BANK DEREGULATION AND ITS IMPACT ON SMALL BUSINESS LENDING

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

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BANK DEREGULATION AND ITS IMPACT ON SMALL BUSINESS LENDING

WEDNESDAY, MAY 19, 1982

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES, COMMITTEE ON SMALL BUSINESS,

Washington, D.C.

The subcommittee met, pursuant to notice, at 9:48 a.m., in room 2359-A, Rayburn House Office Building, Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

Mr. NOWAK. The subcommittee will come to order. I would like to welcome everyone here. We will start with a brief opening statement, and then we will get right to our witnesses.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. NOWAK. Today, we begin our investigatory hearings on banking deregulation and its impact on small business lending.

The proposed measures to deregulate the banking industry could have a profound effect on the basic structure of traditional lending practices in this country. In view of this trend, it is important to examine the possible impact that these changes may have on credit availability, especially for small business.

As a general rule, small business is experiencing difficulty in securing debt and equity capital. For instance, small firms, to a large degree, have been denied access to the bond market and the commercial paper market which are significant sources of debt capital for larger enterprises.

Therefore, small business has consistently relied upon commercial bank credit to meet its financial needs. In fact, a recent survey of bankers by the Interagency Task Force on Small Business Finance indicates that 72 percent of the money borrowed by small businesses comes from commercial banks. In addition, the same survey points out that small and medium sized banks provide the bulk of the dollar volume of bank loans to small business.

In view of the heavy dependence of small business on the banks and banking industry in meeting its financial needs, let us take a brief look at recent developments affecting the industry.

The current high and volatile interest rates have left the thrift institutions on the verge of collapse. A recent business journal article indicates that savings and loan associations' losses totaled $5 billion last year and mergers were responsible for the elimination of approximately one thrift institution a day.

The basic reason for the decline of the savings and loans is that they are being forced to pay more for funds than they are receiving from their long-term mortgage portfolios, many of which were negotiated prior to the advent of new mortgage instruments, such as the variable rate mortgages.

Commercial banks are also experiencing difficulties which are partially attributable to the current high interest rates. More specifically, regulation Q limits the amount of interest that can be paid by insured commercial banks, mutual savings banks, and savings and loan associations.

Although Congress has responded to this problem through the Depository Institutions Deregulation and Monetary Control Act of 1980, banks continue to receive competitive pressure from such creative financial instruments as money market mutual funds.

Another major trend in the financial services industry is the rise of the financial service-type supermarkets such as Sears, American Express, and Merrill Lynch.

Basically, these unregulated financial service operations, in addition to being able to provide customers with a high return and increased liquidity, are able to provide their customers with the convenience of a vast array of investment services.

The banking industry itself is sharply divided on the issue of bank deregulation. Many large banks, for example, would advocate total deregulation, letting the competitive free market determine the survival of these institutions.

However, many small and medium sized banks argue that total deregulation could lead to obliteration of local community-based banks by merger and acquisitions. These banks contend that such a proposal would effectively eliminate a major source of financing for farmers, small business, and certain local customers.

With these various issues in mind, I want to welcome all of our guests here today. And as we did with our tax hearing, hopefully, we will put together reports that will go to the banking committees and the other committees of Congress who will deal directly with this legislation.

I want at this time to introduce Byron Dorgan from North Dakota who has been very concerned about this problem.

Mr. Dorgan, would you like to make an opening statement?

Mr. DORGAN. Thank you, Mr. Chairman.

OPENING STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. DORGAN. I testified late last year in the Senate at hearings held by Senator Garn on this subject. These issues, raised by the prospect of deregulation of the banking industry, are some of the most important issues that America will have faced in a long time. They are particularly important issues for small to medium sized businesses and independent business in our heartland.

The Secretary of the Treasury is pushing for a complete homogenization of our financial industry. It is sheer economic stupidity to believe that if we tear down decades of banking regulation and allow total free competition that the kind of banking institutions

that have served my home community of Regent, N. Dak., and have served Bismarck, N. Dak., and other communities like them throughout the country will survive in the face of competition from Citibank, Chase Manhattan, and others.

I think they should survive. The independent banker who serves my home community is a banker who is critically important to the economic development of the region. The banker knows the people the banker serves. The decisions on loans are not made in a boardroom 1,400 miles away. They are made at home. They are made on the basis of firsthand knowledge of the small business or the family farm producer as to how that business or producer operates and how that business or producer manages his or her affairs.

It is critically important for us to do what we can here in Congress to provide a climate in which the independent banker can continue to compete.

Secretary Regan has provided the principal stimulus for this banking deregulation. As I said, the complete homogenization of the financial industry will someday give us one-stop financial supermarkets in retail chains all across the country with decisions made in large banking centers. I think that's a picture of America's future that I don't relish. And it's the type of future that I intend to try and fight against here in Congress.

Calling these hearings, Mr. Chairman, is a good way to go about it. Some will wonder why these hearings aren't being held by the Committee on Banking, Finance and Urban Affairs, but it is pretty clear that what happens to the independent banks in this country will have a dramatic effect on the small business community and the independent producer. The family farmer and the people on "Main Street" rely on the independent banks for debt capital. And so I am very interested in today's testimony. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you very much. I know of your concern in this area. And what we really want to do is create a record so that the members, as the legislation starts to move through the Congress, can keep in mind the impact of all of this on the small business community. Some of our subcommittee members could not attend today because there is a markup on some of the export-import legislation going on now, and the Judiciary Committee is also meeting. But we are going to have everybody's statement placed in total in the record, and the statement and testimony will be printed for their perusal and guidance as we go through consideration of this very, very important subject.

Our first witness today is Mr. Frank Swain who is the Chief Counsel for the Small Business Administration's Office of Advocacy. And he is from the western New York city of Corning. He is a graduate of Colgate University and Georgetown University Law Center. He has previously practiced in New York State, and was formerly the legislative counsel for the National Federation of Independent Business. He comes with a broad background to our committee, and we will certainly be interested in your comments.

Your statement, Mr. Swain, will be inserted in the record in total. You may proceed as you so desire.

TESTIMONY OF FRANK SWAIN, CHIEF COUNSEL FOR ADVOCACY, SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. Thank you, Mr. Chairman. And I, too, would like to add comments to those of you and Mr. Dorgan. I think it is tremendously important that this subcommittee is taking the time and effort to attempt to develop a record on the key issue of how the call for various types of deregulation of the banking and financial industry has an impact on small business. With respect to banking issues, there is always so much going on within the Congress and within the relevant administrative agencies.

And I at least get the feeling that it is all driven by dynamics within the industry. And by the people that follow the industry very closely. Very little of the legislative and policy changes going on are driven by the dynamics of the ultimate customers for financial services. And in many cases, as your statement pointed out, the customers, small business, are the prime customers of the banks; particularly, banks at the local level.

I do have a statement and I will attempt to summarize it and excerpt some aspects of it. And I will be happy to take any questions afterward.

We are all aware of the dynamic changes taking place in the financial services industry. The Office of Advocacy believes that it can play a vital role in sharing with this committee relevant information.

I might add, Mr. Chairman, that we are in the process of developing more information and data, and we certainly will look forward to the opportunity of making this available to you on a continuing basis.

We have three principal concerns which we would like to share with you this morning involving financial institution deregulation.

First, we are concerned about the impact on smaller financial institutions of increased competition among financial institutions as mergers and acquisitions continue, as institutions broaden their base of operations, and as a direct result of the policies being considered here today.

On more than one occasion we have heard that existing antitrust laws are sufficient to monitor any anticompetitive practices which may occur in the financial services industry. With regard to liberalization of nationwide branching, safeguards should be designed to complement existing antitrust laws while minimizing the prospect of a significant increase in nationwide concentration.

Such safeguards could include limits on regions or product markets to be entered, or limits on the size or market share of banks which might be acquired.

We would encourage the Department of Justice and the financial regulatory agencies to monitor all types of institutional activity—bank, thrift and nonbank. This process should extend down to the smaller communities of America where the small business person is totally dependent on one or two local institutions for its lifeline.

Our second concern is that an organized regulatory environment should be developed for the financial services industry, and that regulation should be evenhanded across all segments of the industry. In addition, in each segment, consideration should be given to

size so that regulatory costs will not be unduly burdensome for our smaller financial institutions.

A classic illustration of the conflicting and confusing regulatory environment within the financial services industry was recently demonstrated when the Federal Reserve Board rejected the application of Central Pacific Corp., a Bakersfield, Calif. bank holding company, to acquire a troubled savings and loan association.

At the same time, the FSLIC was accepting bids from banks, bank holding companies and other nonbank financial firms to acquire the failed Fidelity S. & L. Association of Oakland.

The Chairman of SEC recently recommended that existing regulations and industry classifications be examined within a framework of a one year task force to treat the whole issue of all types of financial institutions. This is an idea that we feel is worthy of great attention. There is just so much going on in so many different areas. There is no central place, aside from periodicals and trade association publications, where you are really able to get a handle on it, and where there is any degree of uniform or focused discussion.

We think a focused one year task force approach is certainly a commendable idea. And if such a task force is used, it should involve members of not only the banking agencies and the administration, but certainly members of the Congress.

You know the social security issue, which is an equally sticky issue in a different way—they are trying to work their way through a commission. And perhaps a properly structured commission is the way to go on the banking issue as well.

Our third concern is related to our first two concerns. When we were trying to develop this testimony in our office, we went through about 12 drafts of this statement. And the phrase that we started to use is "like wrestling in soup." There is just no firm handle on any of the regulation questions as far as we are concerned, and their impact on small business.

You can talk a long time about the question of whether there ought to be interstate branch banking, but then when you take a look at a lot of what is going on already in terms of acquisition of certain financial companies by nonfinancial companies, and you take a look at the impact that money market funds have, and when you take a look at the general information about where small business gets its loans, we all know intuitively that they come from local banks. But there is really very little information available. No data is being collected within the banking community on a regular timely basis and in sufficient detail to enable such an assessment to be undertaken.

In this regard, as you mentioned, the Interagency Task Force study on small business financing illustrated a lack of information on the flow of commercial and industrial loans to small business by small business size categories. We think this situation has to be remedied. We recommend that a statistical data base be developed to collect data on the flow of funds to small firms, so that monitoring the impact of competition and deregulation on small business over the upcoming years will not be overlooked.

This information could be used, for example, by the Justice Department and other regulatory agencies to respectively determine

the competitive environment and the effectiveness of controls instituted in this deregulatory environment.

I would like to reiterate for a moment something that you alluded to, Mr. Chairman, in your opening statement. The small business community is a major user of credit, and the financial services industry has legitimate and serious concerns relating to the impact of changes on the orderly flow of funds and the continued availability of services.

We all know the statistics about small business job creation and innovation. Suffice it to say that rising inflation, increasing deficits, lower savings rates, and a tax structure favoring borrowing for housing investments has resulted in an environment that is unfavorable to business financing in general, and small business financing in particular.

To give you a perspective of small business access to the credit markets, we have illustrated in our testimony some tables with some figures. Small business, categorized as small nonfarm, noncorporate debt raised 6 percent or $5 billion out of a total of $82 billion of funds raised, excluding equity, in 1967.

Thirteen years later, by 1980, although the dollars increased the category decreased to only 4 percent of total funds raised. Small businesses always operated under something of a handicap in the competition for funds, but the impact has been even more severe during this recent sustained period of high interest rates. Although this category does not capture all of small business, it does serve to illustrate the credit raising capability of a major segment of small business.

We also include another table which indicates that most small businesses receive a good deal of credit from trade credit sources, leasing companies and other sources. Although not shown on this chart, two-thirds or more of the small businesses surveyed in that particular study said that they relied strongly on local banks for all types of business and personal secured and unsecured loans.

As you have indicated, the Interagency Task Force study, which was published in February, had results which showed, among other things, that bankers believe that the commercial banking industry is the major institutional source of small business credit; that most small business credit is held by banks of less than $1 billion in assets.

And one other interesting point. Interest charges on small bank loans to small business borrowers were lower on average than comparable rates charged by banks with over $1 billion in assets.

Clearly, the small business community is heavily relying on the smaller sized banks.

A simultaneous inquiry to this Interagency Task Force study was conducted by my office. The interesting thing about the Interagency study is that they didn't even ask questions of the customers. All their data was based on questions to the bankers. We attempted to ask questions to customers. Of those that responded specifically to our questionnaire on bank characteristics—we are talking about small businesses now—about 50 percent noted that small and local banks had strong characteristics that they felt were favorable to their lending practices.

Over two-thirds of the respondents believed that size or location of a bank affects its willingness or ability to meet their credit needs.

Overall, this effort indicates that the security of the banking relationship for a small business customer is one of the most valuable and tangible assets these small customers have. Without the support and financial assistance of the local banker, the small business firm has effectively lost its ability to finance itself. Small business is clearly concerned about credit availability.

I would like to discuss just briefly, Mr. Chairman, the issue of interstate branching. Frankly, we don't know all the answers on this. Our statement doesn't contain a firm position all in favor or all against it.

To be very candid, I'm not sure that interstate branching is the most important issue involving small business financial services. Some bankers that we have talked to are certainly very apprehensive about interstate branch banking. Some States that have within the States a form of branch banking seem to perform fairly well. Other States don't seem to have as good a record. The studies are all over the lot on it. The fact that interstate branch banking is being pushed by the large money center banks doesn't lead me to think that it's going to be any great help to small business. But on the other hand, in all candor, we haven't seen anything in the evidence on the other side that indicates that it is going to be absolutely terrible for small business either.

The issue that I think is at least of equal significance for small business is the regulation Q situation. Banks are now limited to offering a lower maximum rate of return on deposits than money funds are offering. I think regulation Q is a little bit like closing the barn door after the horse has escaped, and the horse is, of course, the deposits are going into the money funds.

The fact is that many local customers—individuals and small businesses—are putting their cash on hand in money funds where they can get returns of 12 percent and 14 percent, or higher, and avoid standard passbook approaches. This takes money just as effectively out of the local communities as any money center bank would through an ownership program. We think that it is very important to small business financing over the long run that the local commercial bank be equipped with the wherewithal to compete effectively for sources of funds both with large money center banks and with money funds.

It certainly is going to be a new era in terms of banking relationships. What we are seeing now, of course, is that small businesses are willing to shop around for the best return on their money. And I think we are going to start seeing small businesses willing to shop around for the best credit situation, especially as interest rates come down 2 or 3 percent and there is a greater demand on credit. I think that what we have to do is make sure that all the financial institutions, whether they are commercial or savings and loans or money funds or whatever, are starting off on the same foot and have the opportunity to offer the same realm of services to small business so that small business has the maximum opportunity to pick and choose among those services.

Particularly important is the issue of accessibility of long-term capital for new and growing businesses. We think that all the time you are looking at this debt side of the issue, you can't overlook the fact that one of the great small business problems is that access to long-term capital in terms of equity isn't very great. Certainly the securities laws, both the State securities regulations and Federal securities regulations, have a major impact on small business' access to the equity markets. Perhaps if there were greater options for equity access then the whole issue of debt and interest rates might be less troublesome for at least some of the small businesses. And we would urge the committee to consider this aspect of the issue as well.

My testimony sets out a number of strategies that are being used by small and regional banks. For men in the market, banking is certainly an exciting industry to be in now. I had a banker tell me just last week that there probably have been more changes occurring in the last 30 months than have occurred in the preceding 30 years.

There is no reason that these changes shouldn't be carefully monitored so that they present small businesses with new opportunities. As I suggested, we don't certainly purport to have all the answers. We are just in the process of trying to develop some information and make it useful to you and to other people in the Congress that are considering these issues. But we certainly urge you to continue your focus on looking at the small business impact of banking and financial institution issues.

We don't feel that the financial institution regulatory agencies or some of the other spokesmen that have been involved in this issue have necessarily been fully aware or very much concerned about the small business aspects of these issues. And we would offer our assistance in helping you continue to look into the issue, and to develop your record.

We do have presented in the statement a summary of findings from a research report that the Hudson Institute did. The Hudson Institute findings basically indicate a fairly rosy future. The findings are interesting, and they are certainly worthy of discussion. We think it is just the tip of the iceberg. And a lot more work needs to be done in investigating some of these issues.

I appreciate your time and patience and would be happy to take any questions.

Mr. NOWAK. Thank you very much, Mr. Swain.

[Mr. Swain's prepared statement follows:]

PREPARED STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, SBA

Mr. Chairman I appreciate your inviting me to participate in this very important hearing concerning Banking Deregulation and Small Business.

We are all aware of the dynamic changes taking place in the financial services industry. Sometimes such an accelerated rate of change tends to obscure what is important to our Nation's small businesses and small financial institutions at the local level. Community financial institutions, however, have always been the catalyst for small business growth within individual communities. The Office of Advocacy believes it can play a vital role in sharing with the Committee relevant information on how banking deregulation and the changes in the financial services industry may be affecting small firms and small financial entities. Since there is a dearth of information on the impact of these changes on small business, it is important to provide some perspective and raise the relevant issues based on the limited information available.

We have three concerns which I shall share with you:

First, we are concerned with the impact on smaller financial institutions, of increased competition among financial institutions as mergers and acquisitions continue, as institutions broaden their base of operations, and as a direct result of the policies being considered here today.

On more than one occasion we have heard that existing anti-trust laws are sufficient to monitor any anti-competitive practices which may occur in the financial services industry. With regard to the liberalization of nationwide branching, safeguards should be designed to complement existing antitrust laws while minimizing the prospect of a significant increase in nationwide concentration. Such safeguards could include, limits on regions or product markets to be entered, or limits on the size or market share of banks which might be acquired. We would encourage the Department of Justice and the financial regulatory agencies to monitor all types of financial institutional activity-bank, thrift and non-bank. This process should extend down to the smaller communities of America where the small business person is totally dependent on one or two local institutions for its lifeline.

Our second concern is that an organized regulatory environment should be developed for the financial services industry and that regulation should be even-handed across all segments of the industry. In addition, in each segment, consideration should be given to size so that regulatory costs will not be unduly burdensome for our smaller financial institutions.

A classic illustration of the conflicting and confusing regulatory environment within the financial services industry was recently demonstrated when the Federal Reserve Board rejected the application of Central Pacific Corporation, a Bakersfield, California bank holding company, to acquire the troubled Kern Savings and Loan Association of

Bakersfield. At the same time, the Federal Savings and Loan Insurance Corporation was accepting bids from banks, bank holding companies and other non-bank financial firms to acquire the failed Fidelity Savings and Loan Association of Oakland, California.

Chairman John Shad of the Securities and Exchange Commission, recently recommended, along with others, that existing regulations and industry classifications be examined, and a framework established for the consolidation of financial regulatory activities; that excessive, overlapping and conflicting regulations should be eliminated. Chairman Shad called for a one-year task force to develop this framework. For the small banking and business communities, we wholly support this concept.

Our third concern is related to the first two. We feel that steps must be taken to document the impact on small business of the structural, regulatory and legislative changes occurring within the financial services industry today. The ability to assess our decisions, as to their effect, is absolutely necessary in determining future policy. In the banking community, no data is being collected, on a regular, timely basis and in sufficient detail to enable such an assessment to be undertaken. In this regard, a recent Interagency Task Force study on Small Business Financing illustrated the lack of information on the flow of commercial and industrial loans to small business by small business size categories. This situation must be remedied. We recommend that a statistical data base be developed to collect data on the flow of funds to small firms, so that monitoring the impact of competition and deregulation on small business over the upcoming years, will not be overlooked. This information could be used, for example,

by the Justice Department and the regulatory agencies to respectively determine the competitive environment and the effectiveness of controls instituted in this deregulatory environment.

Background

We believe the basis for our recommendation for deregulation and our concerns can be seen in the existing structure and recent developments in the financial services industry. The industry is the collection of firms or divisions of firms principally in the business of lending money, managing money, making markets, transferring funds, or providing insurance. Among the various kinds of institutions which serve as financial intermediaries are depository institutions, investment firms, insurance companies, and pension funds, financial conglomerates, finance companies, factoring and leasing companies, Government lending and insurance agencies, etc.

The financial services industry consists of 50,000 firms which include 15,000 banks, 5,000 savings and loan associations and mutual savings banks; 22,000 credit unions, 4,000 insurance companies; and 3,000 broker-dealers, specialists, floor brokers, and mutual funds. The industry and its components consisted of $3.7 trillion in financial assets in 1980.

The forces of inflation have resulted in the creation of new instruments and institutions, an escalation of interest rate deregulation, intensified pressures to reduce geographic restrictions, a greater burden on deposit insurance agencies and regulatory agencies responsible for administrative actions to aid troubled institutions, and increased monetary control over financial firms.

Competition and regulation have resulted in industry consolidation, a financial services smorgasbord environment and fewer distinctions between allowable activities of commercial banks, thrifts, investment bankers and broker-dealers.

Cross industry takeovers and entry from other industries continues to build steam as firms seek access to financial resources, data processing capability, economies of scale production, and tax incentives resulting from portfolio losses or other tax losses.

Through mergers and acquisitions, Prudential, American Express and Sears, to name a few, are each engaged in insurance, savings and loans, foreign banking, travelers checks, credit cards and mortgage banking. They have each also recently acquired a major securities firm. The Bank of America, Security Pacific and various savings and loan associations have also announced their intentions to enter the securities industry. Merrill Lynch, E. F. Hutton and other securities firms have acquired insurance companies. Shearson has acquired a trust company. The list continues.

New financial instruments which have sprung up include money market funds, cash management accounts, variable annuities, guaranteed investment accounts, financial options and futures, retail repurchase agreements, NOW accounts, all-savers certificates — and many more.

The financial services industry has been considered a growth area as both businesses and individuals have become increasingly sensitive to high interest rates and have sought increasingly sophisticated money management services.

Technology innovations such as electronic funds transfer systems provide the opportunity for new arrangements and greatly increase the efficiency of transmitting financial services from non-traditional locations and over long distances.

In response to pressures to allow depository institutions to compete more effectively, P.L. 96-221, the Depository Institutions Deregulation and Monetary Control Act of 1980, was created to provide for more direct price and services competition among depository institutions. While P.L. 96-221 provides for a six year phase-out of deposit interest rate ceilings at depository institutions, this process will not be complete until 1986; thus depository institutions as a group are not able currently to offer rates of interest and terms on deposit accounts which are fully competitive with money market funds.

In this context, we believe the following questions are key to the deregulation discussion:

If the powers of depository institutions are to become more alike or to be broadened to include those of non-depository institutions, how should regulatory arrangements be changed for the different types of institutions? Can a type of activity offered by different kinds of institutions receive equivalent regulation if there are significant differences in other characteristics among institutions offering the service? Would changes in the institutional structure of the regulatory system itself be desirable?

Legislative Issues

The pressure for change in the regulation of the financial services industry generated by the basic structural changes currently taking place, as described above, is reflected in legislative initiatives affecting the industry. Thus, it can be argued that to maintain competitive equity and regulatory balance between depository and non-depository institutions, the central issue is not whether to legislate further changes but what form the legislation should take.

The Senate Banking Committee has proposed broad-ranging deregulation aimed at restructuring the banking and thrift industries. This bill, entitled the "Financial Institutions Restructuring and Services Act" (S.1720) would help regulated depository institutions compete more effectively against money market funds and supermarket investment choices offered by brokerage houses, insurance funds, and retailers. This bill would also dissolve some of the distinction between banks and savings and loans, ease mergers within the industry and relax various consumer protection rules, such as state usury laws.

An Administration drafted bill, the "Bank Holding Deregulation Act of 1982," would require securities activities of banks involving mutual funds, municipal bonds and other government securities to be conducted through a separate affiliate of a Bank Holding Company. Banks with less than $100 million in assets could conduct the same activity through a separate affiliate of the bank.

S.1703, entitled "The Thrift Institutions Restructing Act of 1981," and developed by the Federal Home Loan Bank Board, would expand investment, lending, and deposit powers for Federal thrift institutions in areas

where these institutions already have operating authority, as well as in areas traditionally associated with commercial banks; it preempts restrictions imposed by states on due-on-sale provisions in mortgage contracts and broadens the authority for the Federal Savings and Loan Insurance Corporation to assist financially troubled thrifts. This bill is incorporated in S.1720 and is identical to H.R. 4724.

H.R. 4603 provides flexibility to the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation and the Federal supervisory agencies to deal with financially distressed depository institutions. A similar provision is included in S.1720. This bill passed the House on October 28, 1981.

Small Business Community Concerns

In the context of deregulation and restructuring of the financial services industry, the small business community, as a major user of credit and financial services, has legitimate concerns relating to the impact of such changes on the orderly flow of funds and continued availability of services. In this regard, small businesses have generated more than half of the new product and service innovations developed since World War II, employ about 50 million people, or half the nation's work force, and rely primarily on the nation's banks to provide them with the means to grow and weather economic cycles. Approximately 15 million businesses, or 99 percent of all U.S. firms fall into this category.

Rising inflation, increasing deficits, lower savings rates, and a tax structure favoring borrowing for housing investments, have resulted in an environment that is unfavorable to business financing in general and

small business financing in particular. To give you a perspective of small business access to the credit markets, as illustrated in Table I, small business (categorized as nonfarm, noncorporate debt) raised 6% or $5 billion out of $82 billion of total funds raised, excluding equity, in 1967. By 1980, although the dollars increased proportionate to the total, this category of nonfarm noncorporate financing had declined to 4% of total funds raised. Small business has always operated under something of a handicap in the competition for funds, but the impact has been even more severe during this recent sustained period of high interest rates. Although this nonfarm noncorporate category does not capture all of small business, it does serve to illustrate the credit raising capability of a major segment of small business.

Due to varying factors, small firms, on average, encounter difficulties in issuing and marketing certain types of securities, generating internal funds for investment projects, and finding sources of credit in addition to the small banks within the commercial banking industry.

Table 2 summarizes a survey conducted in the southeast part of the country in November of 1981, which shows that of the non-banking sources of funds available to small firms, 68% of those surveyed relied on funds from leasing companies and from trade credit. (For purposes of this study small business was defined as 3 to 100 employees). Although not shown on this chart, two thirds or more also said that they relied on local banks for all types of business and personal, secured and unsecured loans.

This reliance was confirmed by a recent study on small business finance which was undertaken by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency in consultation with the Bureau of Census and the Small Business Administration. The results indicated that:

- Bankers believe that the commercial banking industry is the major institutional source of small business credit.

- Most small business credit is held by banks with less than $1 billion dollars in assets.

- Interest charges on loans to small business borrowers by small banks were lower on average than comparable rates charged by banks over $1 billion in assets.

One recommendation from this study emphasized the need for improved data collection on the flow of funds from financial institutions to small business borrowers. This should not be overlooked in monitoring the impact of deregulation and its affect on small businesses over the upcoming years.

A simultaneous inquiry was conducted by the Office of Advocacy. Of those that specifically responded to a question on bank characteristics, approximately 50% preferred small and local banks. In addition, it was found that more than 2/3 of the respondents believe that size or location of a bank affects its willingness or ability to meet their credit needs.

Overall, this effort indicated that the security of a banking relationship for a small business customer is one of the most valuable intangible assets these small customers have. Without the support and financial assistance of the local banker, the small business firm has effectively lost its ability to finance itself. Any actions or legislation which could change these existing relationships or the flow and pricing of credit, therefore, are of special interest to the small business community.

Small business is clearly concerned about credit availability in a deregulated environment. But many commercial banks, which represent potential alternatives, experience difficulty getting into local credit markets.

This is one result of legislative actions which have effectively restricted entry of new banks into localized markets. Small banks make the majority of small business loans. However laws prohibiting branch banking or restricting the areas in which branches may be established have had a significant impact on the creation and maintenance of localized banking markets.

Some would argue that allowing larger banks to branch into other areas is of little value to small firms, since large banks prefer to deal with large customers. There exist large banking concerns which are actively forming specialized small business lending units because they think its good business.

Proponents of liberalized branch banking believe that the resulting increase in competition for banks' customers may promote a more optimal banking structure which will improve the availability of affordable credit to small businesses.

The concern for credit availability is reflected in the argument that permitting interstate banking will lead to the subsequent failure of small rural banks. This argument is unproven as yet. A few studies exist, however, to support the contention that penetration of local and otherwise isolated banking markets should lead to a more efficent market, particularly with regard to performance variables such as interest rate and credit availability. Additional studies have shown that in certain states with the liberalization of branching laws, smaller banks have survived and some have prospered under the pressures of new entry. These state studies, however, may not be reflective of geographic and demographic characteristics more typically found in other parts of the country.

The small business concern for credit availability is also reflected in the increasingly repeated question of whether liberalized branching will lead to increased bank size and hence discriminate against small business.

One thought is that as banks expand into local markets through branching, the levels of risk and demand for loans will vary in each separate market and may tend to offset each other. Thus the level of overall risk may be lower (than levels prior to branching) and these

banks should be able to allocate more of their resources towards loans rather than toward safer investments, such as securities which may not provide any direct benefit to the local market.

Small business is concerned that branch banking will divert money from some localized areas as local banks become nothing more than deposit windows for their parent banks. Local thrifts and community banks are currently investing in money market CDs. Given the current economic environment, branches of money center banks would react in a similar manner under relaxation of interstate branching laws. Even if rates fell, would the money go back to these communities the same as it has in the past? The Merrill Lynch chief economist says he doubts it. Bankers admit that traditional lending terms are gone and that most small businesses will not have the profits to risk in short-term, adjustable-rate borrowings.

This may sound difficult for small business in the short-term, but two things are certain: first, some banks will continue with a specialty in small business lending, and secondly, the banks, along with savings and loans and non-depository institutions cannot <u>all</u> lend to big corporations and invest in money market funds, in lieu of their local communities.

The Glass Steagall Act of 1934 prohibits banks from involvement in both commercial and investment banking activities. Legislation has been introduced to reform this separation of financial services. We don't know what effect changes in the Glass Steagall Act will have on small enterprises, nor how a union of banking and securities services will affect the cost or availability of financial services. It has been suggested that less restricted participation in the securities industry by commercial banks as well as thrifts, could enhance competition in the investment banking field, provide more efficient and less costly services to corporate issuers and efficiently provide automatic investment services for small investors.

The issue of accessibility to long term capital for new and growing small businesses concerns us since local broker dealers may be affected by the outcome. In an effort to determine what impact possible reduced numbers of local broker dealers would have on the raising of capital for the local small firms, Advocacy recently joined with the Securities and Exchange Commission, to determine the role of regional broker dealers in the capital formation process. The results showed that regional broker dealers managed nearly 80% of all initial public offerings by firms with less than $10 million in annual revenue, during the period of 1972 through 1980. Among high technology and natural resource companies, regional broker-dealers managed 82% of public offerings. In summary, with regard to interest rate deregulation, interstate branching, and Glass Steagall Act modifications, Congress must insure that undue concentration of market power will not adversely affect the competitive environment for financial institutions and their small business customers.

Small and Regional Banking Concerns

Banking deregulation will clearly impact on small and regional banks. It has been reported that there are approximately 14,000 small banks of around $100 million in assets or less, which hold 21% of total U.S. deposits, but make up 88% of all commercial banks. An estimated 300 small banks were acquired or merged in 1980. Experts wonder whether small banks can survive the fast pace of the financial environment, and in what numbers.

Several weeks ago, a group of businessmen representing the Minnesota Association of Commerce and Industry visited my office on their way to separate meetings with the Federal Reserve Board and DIDC staff persons. Among the group, a community banker exclaimed, "We want to be competitive but how can we do so with our hands tied behind our backs?" Smaller or community banks have long been recognized as the primary supplier of funds to consumers, farmers, and small businesses. These bank leaders say that they are not only losing deposits, but they are losing their best deposit customers to money market funds because of the inability to compete aggressively with these funds for their deposits.

Small financial institutions are preparing for what some term as the "continuing onslaught," by fighting back. They are dumping unprofitable business, targeting special customers for special attention, seeking fresh talent, and for many, shedding their roles as financial supermarkets for their communities. Most are determined to stay in business. Current policy favors interstate mergers of troubled savings institutions into commercial banks and this may force many small community banks into similar mergers.

Even regional banks, which have long been important as links between the few big "money center" banks and thousands of small community banks are having to redefine their business of banking. Some have changed their names to emphasize departure from old-line banking. Others have sold off static operations, such as factoring, leasing, and title insurance subsidiaries and begun investing the proceeds in regional banks elsewhere.

For example, some regional banks are already lining up to become a franchisee under the umbrella of First Interstate Bancorp, a California bank holding company. Whatever they do, smaller banks figure their strength is in numbers. The Community Bankers Association of Ohio has enrolled 140 small banks in the state to pool resources such as buying equipment for the bank or for leasing out to customers.

One article in a recent Wall Street Journal issue quoted an officer of a non-bank financial services company as saying, "Banks that don't get their act together will find somebody else doing it for them."

A Look to the Future

In examining the entire area of banking deregulation and its impact on the small business community, I believe it is important to focus on the future. A recent Bankers' Magazine article, cited a study performed by McKinsey and Company in which five other recently deregulated industries were studied to understand what pattern the financial services industry would most likely follow. The study suggested that the industry will most likely emerge from deregulation with three types of firms - national distribution firms with highly integrated operations and heavy marketing emphasis; low-cost producer firms focusing on highly price-sensitive, limited service products; and specialty firms able to capitalize on products and markets not highly price sensitive.

It is thought that this third category of specialty firms will emphasize products or services that cannot be unbundled easily, and will utilize customer loyalty in product or market segments rather than relying on geographic niches. We think the small community banks will fall into this category.

The Hudson Institute of New York recently published a study on "The Future of the Financial Service Industry." In discussing the structural changes for this industry, the following emerged:

- A new generation of inflation-adjusted financing methods is expected to emerge over the next couple of years;

- Smaller depository institutions have offered tremendous resistence to interstate branching, in order to preserve their independence. To obtain the support of these institutions, most proposals will permit interstate branching only via acquisition of an existing institution, which maintains the market value of existing firms;

- There may be phase in and geographic exceptions for a time, however, it appears that interstate branching will emerge in a national rather than regional form;

- Regulation can be expected to be significantly reorganized along functional lines to reflect the blurring of traditional boundaries by market forces;

- Regulation of nondepository institutions will increase;

- Non-mortgage activities of thrifts will not reduce mortgage availability greatly;

- The shift from nonprice competition (locational convenience and service) to interest rate competition means that financial institutions will be forced to charge more explicitly for services—both directly and through devices such as minimum balances;

- Technology will have the greatest initial effect on services to business. Linkages between firms, households, and other units will transform the structure of the industry. The oversupply of depository institution branches will be exacerbated by the growth of electronic banking and interest rate competition.

In conjunction with the above study, with a grant from the Office of Advocacy, the Hudson Institute was commissioned to examine the implications of the critical forces impacting small business financing. The study, entitled "Capital Markets Serving Small Business: Implications of the Rapid Evolution of the Financial Services Industry" is summarized as follows:

- Large banks and other financial institutions are increasingly paying significant attention to small business financing and financial services. They are setting up special units to serve small business, which include: cash management, account reconcilement, bill paying services and loans. The highly visible success of a number of technology companies has contributed to this interest;

- A number of organizations have begun to venture into the establishment of financial service centers. Further steps in this direction can be expected with explicit focus on small business financing;

- Thrift institutions have provided a variety of services to small business owners through their consumer service function. Under broadened powers in the future, those that do venture beyond housing and construction are likely to focus on small business, building on existing individual account relationships. After authority is granted, it will take a number of years before thrift institutions can become important in the small business lending market;

- Fears have been expressed that growth of interstate banking will lead to failure and consolidation of small commercial banks and curtailed opportunities for small business to obtain financing and services. Some reductions will occur, however, new opportunities for small business financing will arise as a result of increased competition;

- Despite growing competition from regional and national banks, smaller commercial banks have been able to compete particularly in the area of small business finance, because most large firms have not held that interest. Additionally, small banks that serve specialized markets will continue to compete effectively.

- Smaller banks should consider pooling resources through participation such as bulk purchase of money to obtain lower administrative costs and lower interest rates;

- Closely related to the question of interstate banking is the issue of the criteria applied and the authorization of bank mergers. There are strong indications that the anti-trust criteria will be modified and market entry into "banking" will be facilitated, thus reducing small business dependence on commercial banks;

- The prospect of expanded powers of commercial banks under the proposed Glass Steagall Act revisions should not give rise to the concern that commercial banks will pay less attention to small business financing needs. Under SEC's rule 415, the so-called "shelf-registration" plan, some financial firms will find themselves crowded out of the big issue market and, may seek to establish a place in dealing with smaller issues and smaller issuers. These firms will build on relationships they now have in commerical and industrial loans. Rule 415 could have a dramatic effect in segmenting the market which may significantly benefit small business.

- A related source of concern has been the effect of the wave of mergers on regional brokerage firms. Some regional brokerage firms will refuse merger because of a desire for independence; some may become subsidiaries of commercial banks. Services may well be expanded to small issues in a host of combinations.

We have not had the opportunity to analyze all the Hudson conclusions, nor are we yet in a position to agree or disagree with the specific findings. Clearly, it is the continuing responsibility of all persons interested in the future of small business to pursue these issues.

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Conclusion and Recommendations

No one can predict what will happen to smaller financial institutions in an unregulated environment. It is, however, inconceivable that they, along with other financial firms, should continue to shoulder the burden of existing regulations. Financial developments have been so fast and substantial that the deregulation effort in the past decade, even with the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, has lagged far behind the changes in the market. A framework for a deregulated financial service industry is urgently needed. It must be emphasized, however, that a rational deregulatory environment should be conducive to the survival of small institutions. Legislation must insure that regulatory costs will not only be controlled, but will be borne proportionately as to the size of an institution.

In this respect, a careful redefinition of the financial service industry would be needed. The degree to which each service and product line is substitutable needs to be quantified for such a decision.

We support the recommendation made by Chairman John Shad of the Securities and Exchange Commission and others that existing financial services industry classifications and regulations should be examined and a framework established for eventual consolidation of financial regulatory activities. Chairman Shad's call for a one-year task force to develop this framework should be seriously considered.

In this regard, the development of an orderly financial environment should include careful monitoring of market activity which may result in a substantial shift in funds and leave local communities cash poor. This information can only be accessed if clear data collection procedures are established. We recomend that the regulatory agencies develop a statistical data base on the flow of services from financial institutions to small businesses and in all communities. Such a data base on each commercial and industrial loan by borrower size will be instrumental not only in monitoring the flow of funds and measuring the impact of deregulation for future policy purposes, but also useful to the Justice Department in determining which acquisitions, mergers, interstate branching practices and banking policies in general may lessen competition and therefore should be challenged under antitrust laws.

In conclusion, the changes occurring in the 1980's in the financial services industry, in general, and for banking deregulation in particular, will cause institutional structural shifts unprecedented in our history. For small business there will be new opportunities to grow and prosper as these new restructured financial entities perceive and exploit the "latent" small business market. We want to see a greater number of institutions providing credit to small business. We feel the greater the number, the greater will be the benefits to small business.

This also has to be a time for cautious and careful public policy assessment. As new technology and corporate agglomerations combine to effectively invest our nation's financial resources, Congress must assure that all parties competing for the small business market can begin such competition on an equal and fair footing.

Thank you, I will address any questions you may have at this time.

Table 1—*Funds Raised in U.S. Credit Markets*

(in billion dollars)

Selected Categories	1967	1968	1972	1973	1975	1976	1977	1978	1979	1980
Government										
Federal	13.0	23.6	15.1	8.3	85.4	69.0	56.8	53.7	37.4	79.2
	(15.9)	(13.9)	(9.0)	(4.2)	(43.1)	(26.4)	(16.8)	(13.6)	(9.6)	(22.4)
State and Local	7.9	9.8	14.5	13.2	13.7	15.2	20.4	23.6	15.5	23.5
	(9.7)	(9.9)	(8.7)	(6.7)	(6.9)	(5.8)	(6.0)	(6.0)	(4.0)	(6.7)
Business	(42.3)	(40.5)	(39.9)	(44.7)	(19.5)	(25.1)	(31.1)	(31.8)	(39.1)	(34.5)
Farm	3.3	2.8	5.8	9.6	8.8	10.9	14.7	18.1	25.8	17.8
	(4.0)	(2.8)	(3.5)	(4.9)	(4.4)	(4.1)	(4.4)	(4.5)	(6.6)	(5.0)
Nonfarm, Noncorporate	4.9	5.2	14.1	12.9	2.0	4.7	12.9	15.4	15.9	12.9
	(6.0)	(5.3)	(8.4)	(6.6)	(1.0)	(1.8)	(3.8)	(3.9)	(4.1)	(3.6)
Corporate Debt	27.3	32.0	46.8	65.2	28.0	50.1	77.1	92.2	110.9	91.8
	(33.4)	(32.4)	(28.0)	(33.2)	(14.1)	(19.2)	(22.9)	(23.4)	(28.4)	(25.9)
Households	21.3	32.8	65.1	80.1	49.7	90.5	139.9	162.6	164.9	101.2
	(26.1)	(33.2)	(38.9)	(40.8)	(25.1)	(34.7)	(41.7)	(40.8)	(42.2)	(28.6)
Total Funds Raised, Excluding Equity	81.7	98.8	167.2	196.1	198.0	261.0	335.3	398.3	390.6	353.9

(1) Figures in parentheses are the percentage of total funds raised.

Source: *Flow of Funds Account*, various issues, Federal Reserve Board.

Table 2

PRINCIPAL NONBANK SOURCES OF FUNDS, SMALL BUSINESSES IN THE SOUTHEAST, NOVEMBER 1981

	PERCENT USING SOURCE
UNSECURED LOANS FROM PERSONAL SOURCES	21%
SECURED PERSONAL LOANS FROM SAVINGS & LOAN ASSOCIATIONS	5
UNSECURED BUSINESS LOANS FROM PERSONAL SOURCES	13
LOANS SECURED BY REAL ESTATE FROM SAVINGS & LOAN ASSOCIATIONS	20
NONBANK LOANS SECURED BY INVENTORY	19
NONBANK LOANS SECURED BY EQUIPMENT	24
NONBANK LOANS SECURED BY BUSINESS RECEIVABLES	17
LEASING COMPANY	68
TRADE CREDIT FROM INVENTORY SUPPLIES	68

SOURCE: DAVID D. WHITEHEAD, "SIXTH DISTRICT SURVEY OF SMALL BUSINESS CREDIT," ECONOMIC REVIEW, FEDERAL RESERVE BANK OF ATLANTA (APRIL 1982), TABLE 2.

Mr. NOWAK. I had the occasion a couple of weeks ago to speak in Massachusetts where the chairman of the board, I think, spoke on the same small business panel, and I heard the economic forecast that he stated. I am sure it is part of the report by the Hudson Institute that you just spoke of.

And it was interesting to look at that from several points of view. Projections of last year were just as rosy for the period we are in now. And like all forecasts, it didn't have all the premises right. It came down with some believable general statements but what it really breaks down to is the actual experience that we have been through over the last 6 or 8 months.

You know this committee has been struggling with the issue of capital formation in general in trying to find ways both internally and externally to get at some of this capital formation for small businesses. And we know the kinds of jobs that have been created in the country. I am not going to go through those various statistics.

But this hearing, I think, is going to focus more and more on the mergers and acquisitions that take place. You are going to have different people looking at controlling different aspects of the banking industry. I agree with you that I think it is a very important subject that no one has really focused on. You know, we look at the much bigger picture and in many instances, the small business community has been coming in a little too late on most of these issues. Hopefully, with your help in our new position, we are going to get ahead of a couple of these issues.

Your statement really does show an awareness and concern. It is very evident throughout your whole statement. Many members have started to look at this issue because in their own communities throughout the country they see these mergers and acquisitions taking place and the red ink that is spilling over. It is probably just as horrendous as the impacts upon the small businesses—that red ink spills over the first loans to be called or challenged or questioned, to be collateralized heavier. There are many aspects of this that I think we are going to have to be very careful with.

You mention a statistical data base that just doesn't exist today. Is there any internal way you feel—I should ask this to the bankers—that we can, inexpensively and yet efficiently generate that kind of information?

Mr. SWAIN. From my understanding of the issue, Mr. Chairman, the best or the closest that we come to being able to track a number of loans that go to small businesses is information from the Federal Reserve Board in which they categorize loans in terms of amounts of loans. So if you look at the Federal Reserve Board figures and see how many loans for amounts less than $100,000 were made over a particular period in time—some people use that as an indicator of small business loan activity.

Of course, you and I know that just because a loan is under $100,000 doesn't mean that it necessarily goes to a small business.

There is nothing now that requires anybody to keep any sort of records in terms of who they give their loans to and size of the business. Two or three years ago there was an interagency committee which put out a proposal that banks be required to keep records of loans in terms of size of business and who it went to. That

recommendation was roundly criticized by the banking community in general. And, of course, it didn't go too much further. It seems somewhat ironic in an era that we are talking about paperwork reduction to say that here may be a situation where we actually need some more information.

But whether it is through a sampling technique or whether it is through a special series of Federal Reserve Board studies, we have got to get some more information on both sides of the issue. As I said, we all know intuitively that the small business in the local town that has a local bank probably gets its money from that bank. What about the small business in a town where there is a local bank and a statewide bank or a national bank? Certainly my experience in Corning, N.Y. where I grew up, three out of four banks in town were locally owned. Some people might consider them locally owned still, but now they are owned by people in Rochester and Syracuse and Buffalo, which doesn't seem local to my little community.

Mr. NOWAK. That's all right. I don't mind. [Laughter.]

Mr. SWAIN. But your Buffalo bank, Marine Midland, is now owned by people in Singapore and Hong Kong. Has that made any difference to its customers in Buffalo? I think those are key issues that we really don't have any answers to, Mr. Chairman. And the debate so far has been pretty much in the philosophical and emotional level. I'd feel a lot more comfortable about recommending some particular positions if I had some better data.

Mr. NOWAK. Hopefully, we can work together and see if we can't get at least a sampling of that and see in the future what this is all doing in the real world.

The banks are really caught in this position of long-term mortgage. And the change that has occurred in the last year and a half has really affected strongly the whole structure of the financial markets, and where and how people invest. And it has changed. People still have that old fashioned notion that we are not going to change by legislation. They are going to invest their money, their own personal money, where they are going to get the highest possible return with the least possible risk. Nothing we do in the Tax Code to put more incentives in on the supply side and give a 50-percent investment tax credit is going to change that. They are still going to use it but unless that changes the whole market strategy, they are still going to look for that objective. And the growth of these money markets—call it the CMA accounts of Merrill Lynch—have just been so phenomenal. We really haven't given the banking community anything to be competitive with or a reason for them to sustain the very position that we encourage them to sustain.

You look at the McFadden Act or others and it is amazing to me that they are in existence as they are even at this stage because of the tremendous transfers that have taken place. How we expect them to fulfill their commitment to small business and housing and keep this general movement going is very difficult to understand. When you talk about the shifts that have occurred in just the basic structure, forgetting what is coming into the system now with Sears and the other so-called supermarkets. I wonder how they do it. In this period within a year and a half they have just drasti-

cally changed this whole operations system. Unless we can adjust to it, unless small business has some access to those dollars, it is going to be very difficult to, I think, sustain the growth. If we don't do that, you are talking about higher unemployment, and everyone wants the deficits to go down. But there are counter-initiatives out there pushing and pulling against each other.

As Secretary of Treasury Regan said here recently, we are dead in the water. Perhaps even worse than that. I just feel like it is going to be a longer pull than was generally acknowledged or recognized.

But in any event we hope that in your new position you can give us a lot of input. We will take the time to go through every detail we can to insure, as you are recommending here, that small business is thought of and provided for in total deregulation legislation. If there is any other information on this subject, we would be happy to hear about it, and we will hold the record open if you have any other further information on it.

Mr. SWAIN. Thank you, Mr. Chairman. We will definitely keep you advised and look forward to the opportunity to work with the subcommittee staff.

Mr. NOWAK. Thank you very much, Mr. Swain.

Our next witnesses are with the Manufacturers and Traders Trust Co. of Buffalo, N.Y. They are Mr. Robert R. Banta, executive vice president, who is accompanied by Robert H. Edwards, vice president, council, and secretary of that organization.

Mr. Banta is the executive vice president of the bank, which is a $1.8 billion regional commercial bank headquartered in Buffalo, N.Y. As executive vice president, Mr. Banta is responsible for all corporate activities of the bank. In addition, he is chairman both of the Asset and Liability Committee and the Senior Loan Committee. He is a graduate of Rutgers University and holds an M.B.A. degree from the Wharton School of Business in Finance and Commerce. He has been very active in community affairs. We welcome both Mr. Banta and Mr. Edwards to the subcommittee, and I might just say, Mr. Banta, that your complete statement will be inserted in the record in total. You may proceed as you desire.

TESTIMONY OF ROBERT R. BANTA, EXECUTIVE VICE PRESIDENT, MANUFACTURERS & TRADERS TRUST CO.; ACCOMPANIED BY ROBERT H. EDWARDS, VICE PRESIDENT, COUNSEL, AND SECRETARY

Mr. BANTA. Thank you very much, Mr. Chairman, and other members of the committee.

Mr. NOWAK. All right.

Mr. BANTA. We do appreciate this opportunity to appear before you and present our views on how laws and regulations are affecting the way banks conduct business with their small business customers.

We believe our many years of experience in small business lending in western New York qualifies us to speak with authority on these subjects.

Today, our remarks will focus on four basic areas which are restricting banks' ability to better serve the small business community.

Specifically, we will address bank regulations, changes in Federal bankruptcy laws, Small Business Administration policies, and high interest rates. We will also discuss the impacts these factors are ultimately having on the availability of bank credit to small businesses. And I guess I would like to stress the word "availability."

M. & T. Bank, formerly known as Manufacturers and Traders Trust Co., is a major regional bank headquartered in Buffalo, N.Y. We have been long dedicated to serving the needs of the small business community. As you have pointed out, with $1.8 billion in assets at the end of 1981, we are the 126th largest commercial bank in the Nation among over 14,000, and we are 14th largest in the State of New York.

Approximately 62 percent of the $645 million worth of commercial loans outstanding are to small businesses. With regard to commercial bank regulations, commercial banks in the United States have operated under a complex web of regulations as a result of congressional legislation enacted over the years. The result of this legislation was to affect the banking business in at least three ways: The activities of banks were restricted to certain geographic boundaries, only banks could offer certain unique products, and rates paid to depositors were limited by the Federal Reserve's regulation Q.

As inflation increased dramatically in the 1970's, the intention of regulation Q was undermined as checking and savings account deposits were withdrawn from banks and invested in financial instruments that yielded higher market rates.

At the same time, brokerage firms began to offer money market funds, which gave depositors with as little as $1,000 an opportunity to earn market rates in return in instant liquidity.

Money market funds exploit the fact that there are no ceilings on certificates of deposit of $100,000 or more. The funds that are siphoned from banks by the money market funds are not invested in small businesses. Second, the core funds that are siphoned off from banks must be replaced with a higher cost source of funds. This, in turn, raises the cost of banks' raw material, which unfortunately means the banks must charge more to their borrowing customers.

Essentially what we are arguing, then, is the earlier lifting of regulation Q, and the repeal of the Glass-Steagall Act.

With regard to bankruptcy act implications, Congress, as you know, adopted the Bankruptcy Act of 1978. Although the law was intended to modernize the Nation's bankruptcy laws, the act, instead, generated an unanticipated rise in personal and business bankruptcies.

The effect of the act has harmed the public and small businesses. Banks have increased their credit standards, resulting in a reduction in the availability of credit to small business.

We would recommend that the Bankruptcy Act be reevaluated, and appropriate changes made to give lenders the same footing they once had, which will increase the availability of capital to small business.

Small Business Administration policy. We have noted a distinct trend to tighten the SBA lending and guarantee standards. As a result of these policies, it has become increasingly difficult to make

traditional SBA loans to the classic startup companies, especially those with needs below $100,000.

Although larger loan requests are considered, the maximum SBA guarantee amount cannot exceed $500,000. In its fiscal 1979 annual report, the SBA recommended that its guarantee limit be raised to $1 million. We strongly support this proposal.

The SBA guarantee program does not require a large investment by the Government. In fact, the cost of these guarantees are minimal. We feel it is an excellent way to increase employment, reduce Government unemployment expenditures, and increase the productivity of the economy. We advocate the raising of the ceiling of SBA loan guarantees from $500,000 to $1 million. And especially an increase of SBA guarantees to higher risk startup companies, especially in areas with high unemployment rates.

High interest rates. Perhaps of all the problems concerning the availability of credit to small business, high interest rates are the most critical issue. High interest rates negatively impact small businesses because they typically have larger amounts of debt, and they pay a higher price for debt than large companies. Further, as interest rates increase, the availability of credit to these small companies diminishes simply because the cost of credit acting as a rationing mechanism becomes prohibitive.

Inflation is the primary cause of high interest rates, and one of the fundamental causes of the Nation's economic problems. We view the continuing reduction of Government spending as an essential toward ultimately reducing interest rates. Therefore, we strongly urge the Congress to continue its efforts to reduce inflation by attempting to balance the budget. Relatively lower levels of Government deficit spending will mean less Federal borrowing and competition for funds in the marketplace, with businesses whose success is vital to the economic health of the Nation.

The resulting lower levels of interest rates will go a long way toward increasing the availability of credit to small business to provide a remedy for their most critical problem.

In conclusion, M. & T. plans to continue its involvement and commitment to small businesses in the 1980's. We have addressed four broad areas which are restricting the availability of credit to small business financing. As a result of these factors, we recommend, again: (1) The repeal of the Glass-Steagall Act and the earlier lifting of regulation Q to allow banks to freely compete for funds in the market place; (2) the reevaluation of the Bankruptcy Act to reduce obstacles to credit availability; (3) the lifting of the ceiling of the SBA guaranteed loan program from $500,000 to $1 million; (4) the reduction of the Federal budget deficit to allow a lasting reduction in the overall level of interest rates. Taken together, we believe these actions will greatly increase the availability of small business financing, and help improve the overall economic welfare of the Nation.

Thank you again, Mr. Chairman, for this opportunity to address you and your committee. Bob and I would be happy to answer any questions that any of you may now have.

Mr. NOWAK. Thank you very much, Mr. Banta.

[Mr. Banta's prepared statement follows:]

PREPARED STATEMENT OF ROBERT R. BANTA, EXECUTIVE VICE PRESIDENT, MANUFACTURERS AND TRADERS TRUST CO.

Introduction

Mr. Chairman, members of the committee, my name is Robert R. Banta, Executive Vice President of Manufacturers and Traders Trust Company, Buffalo, New York. We appreciate this opportunity to appear before the sub-committee and present our views on how laws and regulations are affecting the way banks conduct business with their small business customers.

Our testimony today will focus on four broad areas which are restricting banks' ability to better serve the small business community. Specifically, we will address bank regulation, changes in Federal Bankruptcy laws, Small Business Administration policies, high interest rates, and the impact these factors are ultimately having on the availability of bank credit to small businesses.

M & T Bank's Commitment to Small Business

Manufacturers and Traders Trust Company, well known as M & T Bank, is a major regional bank that has long been dedicated to serving the needs of the small business community. M & T Bank, which can be traced back to the Manufacturers and Traders Bank of 1856, is headquartered in Buffalo, New York and today has 52 banking offices throughout Western New York State and an office in New York City. Our bank is a full service commercial bank that offers corporate/commercial, personal, international, and trust services to its customers.

M & T Bank is the principal subsidiary of First Empire State Corporation and accounts for approximately 93% of the holding company's assets. With $1.76 billion in assets at 1981's year end, it was the 126th largest commercial bank in the nation among over 14,500 and the fourteenth largest in New York State.

Approximately 62% of the $645 million of our commercial loans outstanding are to small businesses. In contrast, about 10% of the dollar amount of all U. S. commercial banks' commercial and industrial loans are made to small businesses. Not just to mention loans, which represent one aspect of our service mix, M & T Bank provides a wide variety of other commercial banking services to meet its small business customer needs.

In a structural sense, we service small businesses through our network of 52 branch offices located throughout Western New York State, through 25 regional account officers in our branches, and through 35 account officers that work in our Metropolitan Function and in other specialized areas, such as accounts receivable and inventory lending or commercial mortgages, at our downtown Buffalo office, in addition to the hundreds of non-account officers that service small business.

M & T Bank works with a number of local governmental agencies that are concerned with small business funding. We hold 49 Erie County Industrial Agency Bonds, which is more than any other bank in Western New York, amounting to $30 million. Since 1979, M & T Bank has made 23 loans totaling over $15 million to companies through the Erie Niagara Development Agency and the Local Development Corporation of Western New York. About 80% of all these development agency loans are to small businesses.

The Bank also works with a number of Federal Agencies such as the Farm Mortgage Home Administration and the U. S. Small Business Administration. Today, the M & T Bank has a total of 148 loans, averaging about $92,000 each, to small businesses sponsored by the Small Business Administration. Although, as mentioned, we are the 126th largest bank in the United States, we rank 27th in the United States in terms of the amount of our Small Business Administration

sponsored loans outstanding. In terms of the amount of these loans outstanding as a percent of bank assets, we rank 15th in the Nation.

One example of our involvement with small business utilizing many government financing programs is Comptek Research Incorporated. M & T Bank has been a source of financing to Comptek since 1968 when it was formed by four individuals to apply modern computer technology to business and government problems. Since that time, Comptek's sales have risen at an annual average of 40%. Comptek's workforce has grown with its sales growth and the increase in the number of its products and clients. Today, the company employs approximately 500 employees nationwide, with 170 based in Buffalo. Additionally, Comptek is training unemployed individuals in computer programming under a federally-funded program in an effort to help ease local unemployment and a local shortage of computer personnel.

Clearly, this information demonstrates that our involvement and commitment to serve the small business customer is substantial, and we intend to continue these efforts in the future. However, while we are proud of this record, today we are prevented from doing more for the small business community because of a number of handicaps, which we feel government can do something about; but before each of these obstacles is discussed, we would like to briefly review the nature and structure of bank regulation in the United States and some of the dynamic changes that have recently taken place in the industry.

Commercial Bank Regulation

Commercial banks in the United States have operated under a complex web of regulations as a result of Congressional legislation enacted over the years.

Congress passed the Federal Reserve Act of 1913 in response to the money panics early in the 1900s (including the panic of 1907) followed by the Banking Act of 1933 during the Great Depression. These pieces of legislation, along with the McFadden Act of 1927 and the Bank Holding Company Act of 1956, form the basis of much of the banking system today.

The 1913 Federal Reserve Act created the Central Banking System of the United States which ended many of the defects and instabilities of the former decentralized system. The legislation empowered the Board of Governors of the Federal Reserve System to issue regulations and to define specific terms and conditions under which banks could operate, the most noteworthy of which is Regulation Q. Regulation Q specifies the maximum interest rates and terms associated with deposits at commercial banks.

The Banking Act of 1933 further added to the structure of the U. S. banking system. It created the Federal Deposit Insurance Corporation (FDIC), an independent federal agency designed to insure most deposits of U. S. banks. In addition, part of this Act, now referred to as the Glass-Steagall Act, separated "commercial" from "investment" banking. Today, this means banks cannot offer money market mutual funds to the public or underwrite and trade in corporate and municipal revenue securities.

The McFadden Act of 1927 and certain aspects of the Bank Holding Company Act of 1956 together limited banking by a single entity to one state only. The McFadden Act restricted banks from opening deposit taking branches in more than one state, and the Bank Holding Company Act (Douglas Amendment) restricted interstate bank acquisitions by bank holding companies.

The result of these regulations was to affect the banking business in at least three ways: the activities of banks were restricted to certain geographic boundaries, only banks could offer certain unique products, and rates paid to depositors were limited.

Concerning geographic restrictions, commercial banks were one of few U. S. industries which could not cross state lines and in some states could not open branches. However, because of advances in communications and transportation, the nation as a whole has been drawn closer together. Consequently, banks began sending their account officers out of state to call on customers, opening "Loan Production Offices" which cannot accept deposits, and establishing "Edge Act Corporations" that are restricted to international business. Thus, in many ways interstate banking has already arrived.

The exclusive right to offer certain products such as checking accounts was of major importance to commercial banks. Until recent years, no other financial institution had the legal right to handle checking accounts. In addition, banks were forbidden from paying interest on these deposits, that had provided a low cost source of funds which kept down the rates charged on loans. Lower rates on business loans benefited the economy as a whole and especially small businesses, but the low rates paid to depositors were really subsidizing borrowers.

In addition to the fact that banks were forbidden to pay interest on their checking accounts, they were limited by the rates that could be paid on savings accounts by the Federal Reserve Board's Regulation Q. Over the years, checking and savings accounts made up the majority of the "raw materials" used to make

loans by banks, including M & T Bank. Moreover, in many states, including New York State, maximum interest rates were established that could be charged on loans.

Subsequently, changes in a number of factors (economic, regulatory, competitive, technological) both within and outside the industry began to alter the the three prominent features of the U. S. Banking industry.

As inflation increased dramatically in the 1970s, the intention of Regulation Q was undermined as checking and savings account deposits were withdrawn from banks and invested in financial instruments that yielded higher market rates. This "disintermediation" process caused considerable concern for many banks as their "core deposits"--checking and savings accounts--declined. However, when interest rates rose to unprecedented levels in 1979 the Federal Reserve allowed the introduction of a near market rate "six-month money market certificate" which in part displaced core funds.

The exclusive right to offer checking accounts came to an end in New York State in the 1970s, (and for the Nation as a whole January 1, 1981 as a result of the Depository Institutions Deregulation and Monetary Control Act of 1980). As a result, savings and loan associations and mutual savings banks were allowed to offer interest bearing checking accounts, commonly known as NOW accounts--negotiable order of withdrawal.

At the same time, brokerage firms began offering money market funds which gave depositors with as little as $1,000 an opportunity to earn market rates of interest. Essentially heckable and low interest rate bank deposits are withdrawn by small depositors and placed with a middleman that consolidates

the funds and redeposits them in "jumbo" bank certificates of deposit at a higher market rate of interest.

Ironically, banks today are losing funds to money market funds that repackage the monies, extract a fee, and sell them back to certain banks at a cost that is higher than if the bank were not subject to Regulation Q. Although the Monetary Control Act of 1980 slowly raises Regulation Q ceilings to market rates by 1986, in today's high interest rate inflationary environment, this process is not occuring fast enough to allow banks to freely compete for deposits in the market place.

Today, brokerage firms are offering broad based financial service packages, such as money market funds, that access checking accounts and lines of credit. Securities firms are the only institutions that today can legally offer these accounts at market rates of return and instant liquidity. The accounts are obviously very attractive, and there are other industries considering new products offering highly liquid investments that can be accessed via a transaction type of account.

Bank Regulation - Impact on Small Businesses

We are not complaining about the services that these firms offer. These products are good products that are fulfilling the needs of the market place. Rather, because of Regulation Q limits on rates banks can pay to small depositors, and product offering restrictions imposed by the Glass-Steagall Act, we cannot offer the kinds of deposit products we need to be competitive in the market place. As a result of these restrictions, the availability of financing to small business customers is ultimately impacted in at least three ways.

First, most of the "core" deposit funds that are now siphoned away from banks by the money market funds are reinvested in large certificates of deposit at money center banks or other instruments such as commercial paper--essentially a short term loan to the largest and strongest U. S. corporations. Money market funds do not invest in small businesses, in part because they confine themselves to very safe investments with short term maturities.

Secondly, the core funds that are siphoned off from banks must be replaced with a higher cost source of funds such as certificates of deposit or Federal Funds. This in turn raises the cost of the bank's raw materials which unfortunately means it must charge a higher borrowing rate to its customers. Thus, small business customers pay more for a loan than would otherwise be the case, increasing the business' total costs. More importantly, as the cost of credit rises, it becomes less affordable to more and more small businesses.

Thirdly, to successfully gain small business customers and properly service their needs requires a deposit taking facility, namely a branch office. Generally the smaller the size of the business, the more this is true. Banks traditionally have met this need by building more branches and extending their hours to allow customers more convenient access to checking and savings accounts; but with the advent of high rates of inflation, high market rates of interest, and large differentials between Regulation Q savings accounts and market rates of interest; consumers have economized on their checking and savings deposits or shifted them to non-bank market rate financial instruments.

However, banks' high fixed cost "brick and mortar" branches were built to both serve the needs of its business customers and its individual customers. If these branch offices can no longer compete, and their deposit market share

is eroded because of inflation and government restrictions on deposit product offerings and their price, then the continued viability of banks' high fixed cost branch system will be threatened.

If a decline in the number of branch offices, or a lack of expansion takes place, this impairs banks' ability to serve small businesses and the community as a whole through branch offices. The small business' costs rise as inconvience increases, and in some instances, credit availability may decline or its price may be less competitive.

Moreover, all of these banking issues are important to small businesses whether full fledged interstate banking comes about or not. Besides community ties, small businesses will continue to depend upon local or regional banks, versus large money center banks, for financial services. This is a result of convenient access to local branch systems, and because money center banks tend to be less interested in small businesses for economic reasons.

In general, it is more costly and less profitable to do business with a small business customer than a large one because of the relatively higher administrative costs involved compared with the potential revenue. Since it generally costs about the same to make a loan of $5 million as it does a $100,000 loan, all other things being equal, it is more profitable to make the larger loan--something the large banks prefer to do.

Nevertheless, as is borne out by the statistics cited earlier, M & T Bank recognizes the need to support the small business community despite some cost disadvantages, but we must constantly review our position in light of all influencing factors.

Essentially, what we are arguing for is the earlier lifting of Regulation Q and the repeal of the Glass-Steagall Act. If M & T Bank could freely compete for funds in the market place, more funds would be available to small business, and our branch system would continue to expand, serving the needs of small business. As a result, the continued availability of funding for small business would be ensured.

Bankruptcy Act Implications

Congress adopted the Bankruptcy Act of 1978 as the first major revision of the 1898 Bankruptcy Act in 40 years. The new bankruptcy code, attempted to strike a balance between the interests of creditors, on the one hand, and an opportunity for debtors to have a "fresh start" on the other. In the process, many rules which were previously relied upon by the banking community are no longer in effect. Although the law was intended to modernize the Nation's bankruptcy laws, the act instead created an unanticipated rise in personal and business bankruptcies.

Historically, the number of bankruptcy cases filed annually has followed changes in the economy--filings increased when unemployment increased and industrial output declined. After the 1978 Bankruptcy Reform Act went into effect in October 1979, this conventional wisdom was no longer applicable. During the fiscal year 1980, personal bankruptcy cases increased 59% in the United States and in fiscal 1981, the increase was 43%.

In addition, business bankruptcies in the United States increased 59% in fiscal 1980 and 42.8% in fiscal 1981. The increase in the 1979 - 1981 period exceeded

the 1974 - 1975 period when the recession was much more severe and lasted more than twice as long. While a weak economy in 1980 - 1981 was partially responsible for these statistics, most bankers would attribute much of the rise to the Bankruptcy Reform Act. At M & T Bank we have seen an increase of 120% in personal bankruptcies and 98% in small business bankruptcies in 1980.

The new bankruptcy code was intended to allow a corporation, partnership or individual in financial distress an opportunity to restructure its financial affairs and regain financial soundness. The reforms were intended to offer businesses more of a chance of reorganizing successfully, rather than liquidating completely. In an effort to help individuals and businesses, the new code may have overly protected debtors and adversely impacted creditors. The changes in the bankruptcy laws are numerous and complex and it would be inappropriate to list all of them here; but we will briefly review some of important by-products of the law.

Historically, smaller businesses have lacked managerial depth and financial reporting sophistication. Moreover, their leverage (debt/net worth) is generally greater than that of a larger firm. As a result, banks traditionally relied on the collateral value of assets, such as machinery, equipment, and accounts receivable, against which a loan was made. If the company filed for bankruptcy, the bank was reasonably assured that it would receive the collateral that the borrower pledged to the bank at the time of the loan origination.

This is no longer the case today because of a number of changes in the law. It is very possible for a bank to see its collateral position diminish,

decreasing the probability that it will recover its loan funds. Alternatively, it may have to spend an enormous amount of time and effort to protect its interests,which is very costly. In addition, generally, bankers are willing to help a borrower work out of a problem situation. However, recently we have seen a reluctance on the part of some borrowers to work with us; rather, they have chosen the bankruptcy path.

The effect of the Bankruptcy Act has harmed the public in a number of ways. Banks have increased their credit standards resulting in a reduction in the availability of credit to small businesses. Additionally, bank administrative costs due to increased bankruptcies, such as legal fees, are being passed on to all borrowers in the form of higher interest rates.

Lastly, in many cases, the small businessman is not substantially different from an individual consumer. A very small businessman, for instance, may have only the equity of his house to put up as collateral for a loan. Today, because of the exemption status of the bankruptcy law this is unavailable for collateral. Therefore, this business will not be able to find financing in the market place, because the lack of any meaningful collateral makes the loan too risky--or nonbankable in the language of bank examiners.

In general, if a lender believes a prospective borrower is in a business where there is a possibility of bankruptcy during the life of the loan, the lender will either forego the lending opportunity, impose constraints to reduce the probability of loss to the lender, or increase the price of the loan. Furthermore, like other business expenses, costs incurred by a bank because of a customer's business bankruptcy are passed on to other business borrowers in the form of higher interest rates.

As a result of these forces, the Bankruptcy Act has inadvertently acted to restrict the availability of funds in the market place, especially to small business. Thus, we would recommend that the Bankruptcy Act be reevaluated and appropriate changes made to increase the availability of capital to small business.

Small Business Administration Policy Implications

Small businesses represent a major portion of the economy accounting for about 97% of all business in the United States and one half of total business revenues. These companies provide 58% of all private employment and have generated over 96% of the new jobs created in the private sector over the past seven years. Despite their value to our economy, small firms frequently suffer from a lack of financing. Because of their small size, they are not considered for investment by institutional investors. Recognizing this fact, the government established the Small Business Administration (SBA) which has long been an important source of financing for small businesses.

Since its inception in 1954, the Small Business Administration loan approvals in the United States have grown considerably. Prior to the late 1960s, SBA lending activities consisted of joint bank- SBA participation loans and SBA direct loans. In the 1969 - 1978 period, annual loan approvals more than doubled to 30,926 and loan dollars approved increased more than five times to over $3.2 billion. A large part of this growth is a result of increases in commercial bank funding of SBA guaranteed loans. Over 70% of all SBA approved business loans are through its guaranteed program. Typically, SBA insures up to 90% of a loan advanced through a bank.

When the prospective borrower lacks experience, is under capitalized, has little or illiquid collateral, or requires a longer payment period than the average loan, a guarantee by the SBA permits a bank to offer a small business more flexible credit terms. SBA loans are meant to be available only to those firms that could not otherwise obtain loan funds at reasonable costs without a guarantee. In a sense, the SBA guarantee is a substitute for adequate collateral or equity of a firm.

Accordingly, M & T Bank seeks SBA guarantees for loans that do not meet our loan approval standards. We do not seek loan guarantees for those companies that do not need a guarantee, nor for a company that does not appear to have reasonably bright prospects. As a result, M & T Bank SBA loan guarantee programs allow small businesses to obtain funds that otherwise would be unavailable to them.

In the past, SBA guaranteed loans were available only to high risk borrowers. Today, however, less risky borrowers can also qualify for SBA guaranteed loans. In fact, it is our perception, that SBA officials are encouraging banks to submit applications from lower risk borrowers in order to improve the cr 'it quality of their guaranteed loan portfolio. This seems to be contrary to the original purpose and intention of the Small Business Administration--to help fund those small business prospects that would not otherwise have access to financing.

As a result of these policies, it has become increasingly difficult to make traditional SBA loans to the classic "start up" companies, especially loans below $100,000 and $50,000. It appears that SBA lending requirements have become as stringent as a bank's loan standards. Since recent experience has

demonstrated that SBA is often demanding as much loan collateral and "financial track record" as a bank would require for a conventional loan, many start up companies that do not have collateral are not receiving SBA funding. SBA's emphasis seems to be shifting away from these businesses towards businesses that have passed the start up phase and are in the growth stage. Thus, the ability of start up businesses to receive SBA guarantees is becoming more difficult, and so therefore, the Agency is limiting the total availability of funds to small business.

In terms of funding availability restrictions for larger businesses, the maximum guarantee available from SBA is $500,000--a loan of $555,555 can be submitted to the SBA for its full 90% guarantee. Although larger loan requests are considered, the maximum guaranteed amount cannot exceed $500,000. In its fiscal year 1979 annual report, the SBA recommended that its guarantee limit be raised to $1 million, and we strongly support this proposal. This action would greatly increase the availability of funds to small business through the private sector.

The SBA guarantee program does not require a large investment by the government. Total operating losses for fiscal year 1979 amounted to only $660 million in relation to a total portfolio of close to $12 billion. Thus, the costs of these guarantees are minimal, and we feel it is an excellent way to increase employment, reduce government unemployment expenditures, and increase the productivity of the economy. We advocate the raising of the ceiling of SBA loans from $500,000 to $1 million and an increase of SBA guarantees to higher risk start up companies, especially in areas with high unemployment rates.

High Interest Rate Impact

Perhaps of all problems concerning the availability of credit to small businesses, high interest rates are the most critical issue. High interest rates have a number of negative effects on small businesses. Since small businesses typically have large amounts of debt in relation to capital than larger companies, financing costs as a proportion of total business costs increase dramatically at high interest rate levels. In general, small businesses pay a higher price for their borrowings than larger companies because of their higher business risk. Further, as interest rates rise the availability of credit to these companies diminishes, simply because the cost of credit--acting as a rationing mechanism--becomes prohibitive.

In 1969, when the prime rate was 8%, this meant a typical borrowing rate for small business of 10% to 11%. Today, with prime at 16 1/2%, this rate would be 18% to 19%. Clearly, this seriously impacts the highly leveraged small business's cost structure and its desire and ability to borrow at these rates. From the bank's view point, increases in interest rates on small business loans is undesirable, since it raises the small business's total cost and the probability that the loan may not be repaid.

Inflation and its expectation is the primary cause of high interest rates and one of the fundamental causes of the Nation's economic problems. The key to economic recovery is the lasting reduction of interest rates to a level that will permit overall business expansion and alleviate the disproportionate burden on small businesses. We view the continuing reduction of government spending as essential to the economic program, especially in light of the fact that the budget is unlikely to be balanced by 1984.

High government spending and the attendant Federal deficits have had an adverse effect on the economy's performance. Over the years, total capital formation in the United States has been deterred by [illegible] spending which results in heavy federal borrowing, market uncertainty, and high interest rates. Large Treasury borrowings increase interest rates and crowd business borrowers out of the markets. Since the deficit is monetized by the Federal Reserve, it creates a high interest rate inflationary environment that discourages both saving and investment, and ultimately affects the availability of credit to small business.

Therefore, we strongly urge the Congress to continue its efforts to reduce inflation by attempting to balance the budget. Relatively lower levels of government deficit spending will mean less federal borrowing and competition for funds in the market place with the businesses whose success is vital to the economic health of the Nation. The resultant lower levels of interest rates will go a long way to increasing the availability of credit to small business and provide a remedy for their most critical problem.

Conclusion

In conclusion, M & T Bank plans to continue its involvement and commitment to small businesses in the 1980s. We have addressed four broad areas which are restricting banks' ability to better serve the small business community and the impact these factors are having on the availability of small business financing. As a result of these factors, we recommend: (1) the repeal of the Glass-Steagall Act and the earlier lifting of Regulation Q to allow banks to freely compete for funds in the market place, (2) the reevaluation of the Bankruptcy Act to determine obstacles to credit availability, (3) the lifting of the ceiling of SBA guaranteed loans to $1 million from $500,000, and (4) the reduction of the Federal budget deficit to allow a lasting reduction in the overall level of interest rates. Taken together, we believe these actions will greatly increase the availability of small business financing and help improve the overall economic welfare of the Nation.

Mr. NOWAK. We appreciate your taking the time to prepare your statement. I think it is a good one because we have got a bank that has been interested and active in pursuing credit and availability for the small business community. And I know that has been appreciated.

One of the things that is starting to have an effect, of course, is the availability of funds to the banks: The cost of those loans and the outflow. I wonder if you could give us some general views about what your deposit base has looked like over the last couple of years.

Mr. BANTA. Perhaps the most notable transition in the deposit base is a shift of more funds to some of the newer instruments that are now permissible. These instruments come close to being near market instruments, and "market" to me means the money market funds because they are the threshold or at the highest level of rates generally. Of those products perhaps most noteworthy is the tremendous growth in the 6-month money market certificate instrument. It now accounts for approximately 25 percent of our total deposit base although of course, it accounted for nothing only a few years ago when the product wasn't allowed.

That shift of funds has come from other funds, other sources, transitions from savings accounts and demand deposit accounts into those types of instruments. We expect that trend to continue whether it is that deposit product or the newer ones that come out each day. So our mix has changed.

The point, of course, is that we still are losing a share of the market to the money market mutual type of funds because they offer a generally higher rate. More often the instruments you have, CD's in particular, are above the 6-month Treasury rate offer, on which the 6-month money market instrument is based.

So we are not paying a competitive rate when compared to money market funds. And the result is we are growing at a lower rate. In fact, in terms of market share, you are losing market share in the western New York market when you include the money market mutuals by definition.

Mr. NOWAK. The effect of that transfer of dollars from your institution, I assume, and any other banking institution to the money markets would seem to me to leave a void in the availability of funds for your general lending purposes, including small business. Do you have any ideas of where these dollars are, once they get into the money market funds, whether they are in Corning, N.Y., or Buffalo, N.Y? Where they ultimately end up? The majority of those funds.

Mr. BANTA. The typical money market balance sheet that we look at will have the funds that they have taken in and invested approximately two-thirds back into bank certificates of deposit, and the balance of one-third in banker's acceptances, Treasury bills or commercial paper. Some combination.

Now the two-thirds that does go back to the banking system, for the most part, goes back to the very large money center banks. I can tell you we have no certificates of deposit from money funds.

They typically invest them with the larger banks who may or may not then be using those funds to transfer them back to a local lending situation. Whereas the effect on us is to lose the availability of funds. If for some reason we did get a deposit from a money market fund, presumably it would be at a higher cost than if we took it in directly. Inasmuch as it has now been cycled through another channel and there is a cost structure there, that, obviously, would raise our overall cost.

But to answer your question or to summarize it, generally they are in money market instruments in money market centers, such as New York.

Mr. NOWAK. Mr. Centner, you have a question at this point?

Mr. CENTNER. All right. On page 16 of your testimony, you say, "Inflation and its expectation is the primary cause of high interest rates and one of the fundamental causes of the Nation's economic problems." I would like to describe a situation and have you correct me if I am wrong, then address three or four factors. A couple of them are included in your testimony. You don't seem to connect them in your testimony, at least not in your summary. I would like to see if they aren't interrelated.

If you lend out money, your purpose is to make a profit. If there were no inflation, you could make a profit at 3 percent. If there is 10-percent inflation, that same profit would mean you would have to charge 13-percent.

Over the last 51 years, the rule of thumb has always been 2- or 3-percent differential between the nominal and the real interest rate, based on a prime. In actual fact, during the last 51 years, 26 of those years have resulted in a net gain to the lender.

Right now, as the previous witness pointed out and I think one of the other witnesses mentioned in his testimony, the real price of money is extremely high. The real interest rates are far beyond any historical "normal" real interest rate.

We are told there is money to lend. We have bankers telling us that. We have other lenders telling us that. There is money to lend, but not at the present rates, and at returns which imply that not only is the current real interest rate abnormal, but that, in fact, money has been overpriced by the financial markets.

Japan and Germany have had lower interest rates with higher deficits. In fact, the deficit this year is lower in terms of its share of the gross national product than it was 2 years ago when it was a smaller deficit.

Doesn't that say that there is a risk premium being charged by the banks and the other lending institutions? I would suggest the risk premium is based on the following. Fidelity to a game plan has been a problem; the last two administrations that had recessions announced economic game plans and immediately abandoned them after the prime rates were lowered in response to the announcement of those plans. So the financial markets got burned. Isn't it possible that they are saying this time, "Look, maybe your intentions are good, but until we see that you are serious we are not going to react to your announced game plan"? Which raises the question then, wouldn't the worst thing that we could do be to have the administration abandon the game plan that it has already announced and do something different? Wouldn't that simply contrib-

ute to the expectation problem that you mentioned in your testimony?

Second, the bankruptcy laws, which you mentioned as a separate factor—aren't they, in fact, part of the problem? If I'm a lender, I know that a borrower can go into a bankruptcy court today, even though he may get $100,000 in 2 weeks, and show on paper that his liabilities outweigh his assets, and therefore declare bankruptcy and not have to pay me back, doesn't that make him a much greater, tremendously greater risk, than he would be under the older bankruptcy laws which required anticipated income and anticipated expenditures be included in the bankruptcy court proceedings?

I know, for example, when I worked for Associates Discount that we would have somebody in court to make specifically those points in order to protect the company's investments, something they can't do now.

Third, is it possible the banks are making up past losses by charging an inflated rate of real interest in order to cushion the losses that they have already taken? Not because of their own fault, but because of the erratic performance of our Government in fiscal and monetary policy.

And finally, there was a suggestion that prime rates in the major centers—Los Angeles and New York—are kept high because those banks, particularly Citicorp, for example, are covering bad loans in the third world, in places like Poland, by charging the American consumer, the American small businessman and so forth, a higher rate of interest that they aren't getting from those third world countries, countries outside the western world?

I wonder if you could comment on some of those.

Mr. NOWAK. You can answer that yes or no. [Laughter.]

Mr. BANTA. Could I have a replay of that? [Laughter.]

Mr. NOWAK. I think the basic question Mr. Centner was asking was the risk factor and the interest rate. How do you think that plays out in the prime?

Mr. BANTA. I wish I knew. The concept of real interest rates today with the latest statistics are that inflation is at one of the lowest levels in years, and yet we haven't seen the market for interest rates fall as it might have in the past.

In our statement we mention that we are going to have a brief fall and then a rebound right back to the same old inflationary type of syndrome. That, obviously, has to be a factor. But one would have thought that by now the markets would have reflected some of the more encouraging economic data in terms of historical effects in interest rates. Some of the data isn't encouraging when you are talking about building starts and so on, as we saw in this morning's paper.

Mr. NOWAK. Excuse me. Did you conclude your statement on that?

Mr. BANTA. No.

Mr. NOWAK. Before you go onto another point I wanted to ask you a question.

Mr. BANTA. I won't go on long. I suppose that the fundamental problem right now is getting a consistent story on the budget situation. Now whether the game plan should be to abandon it or not to do that, I am not really sure. But the point is a resolution is

needed, and relatively soon, in one form or another to provide some stimulant to the markets.

Mr. CENTNER. Am I understanding what you are saying is that this specific game plan is not as important as getting all the participants to say, yeah, we all agree that this is the way we will go?

Mr. BANTA. Some resolution to it, whichever way it is, as opposed to letting it drag on as it has now for many months.

Mr. NOWAK. Just to try to expand on that, I am concerned about the other factor. That's brand new here. For many years, the Federal Government has gone back and forth. As Rick pointed out, we have had higher deficits when you take it as a percentage of gross national product. One point in our history is that in the booming 1950's, or the late 1940's, our deficit, as a percentage of our gross national product, was up in the 55-percent range. We lived through that, and we have been able to have peaks and valleys. But we have got to where we were a couple of years ago.

Isn't this a very important factor? That the basic financial structure of this country has changed with the advent of the money markets and the competition from the money markets where they are not regulated. The whole technology has given them the opportunity to move into a market where they have never been. And despite what we do with the budget, despite what we do if we could get agreement, we will have a $90 billion deficit instead of $102 billion deficit. Do you mean that $12 billion difference is going to just move this whole interest rate from 16 to 8 again?

I am wondering if we are not sort of looking at a different basic structure here. In the past, if you had passive investments and you looked at a bank account, I can remember many people saying, well, I've only got 14 years and 8 months to wait until I double my money. Today, you can take passive money and double your money in 4.8 years or something. So you have got a different structure out there.

I am wondering how these interest rates are going to fall when on the other hand you have no regulation Q out there anymore. You have a regulation Q, but the money markets don't have a regulation Q, and they are going to be paying 14–15 percent. The bigger banks are going to be borrowing money from them at that rate, and I don't think they are going to borrow that money out at any lower than they are paying. That sets the ceiling that you now have to come under somewhat, but you are certainly going to have to borrow your money—and if you are going to attract any money, you are going to have to get near that rate that that money market is paying.

This whole basic change in the last year and a half with the advent of these money markets—what's the figure now? How many billions have they got in the money markets? It's close to $200 billion, I think. And that's a lot of cash laying around. That is in the system and yet seems to be a catalyst for a rate to the whole system now. That wasn't around a couple of years ago.

As Rick said, if you didn't have that out there, would not have that rate then, as we are now getting back into single digit inflation, if you were in a normal environment that you have been in for 40 years, wouldn't that have started to bring that interest down to at least a much lower rate than we are seeing?

Mr. BANTA. Well, I think your comments are very appropriate in the sense of passive types of investment concepts. But on the other hand, if everyone in a longer time arises and begins to be involved in passive types of investments, that money has to come from some entity. And another thing, wherever it came from, whether it was the stock market or a small business that was sold or liquidated or something, and the funds were put into some instrument as they exist now or might exist by the mideighties, and with the aim of doubling their money in almost 5 years at around a 15-percent rate, sooner or later there will be less takers on the other side because of the liquidation of these other funds from which the past investment was started.

So I think the free market forces, in the long run, will work to reflect what is the very high, real rate of return now. The long-term study of interest rates that I was familiar with in school by Sidney Homer and the Solomon Brothers firm who have traced these things back for hundreds of years shows that we are at higher levels of real rates now that we have ever seen. Yet, in the history of rates, it is a relatively short time rise, and I think the market forces will correct that imbalance. I don't think you have to be too concerned about everyone becoming a passive investor in the long run as the demand for the money will fall off and, hence, the price that the passive investor can obtain will decrease.

The clearest example of that is, who would have ever thought 2 or 3 years ago that the price of OPEC oil is doing what it is today or has done in the last 6 months or so. Basically, that's a world market and a free market for the most part. It's just another economic example of market forces at work.

I think that sooner or later the real rates will be reflected in lower levels of rates. We might be getting close to that threshold in the current week or month. I think a catalyst would be a solution to the budget situation. Now that may move rates one way or another—6 months from now there could be some other factor that will influence them in another way. But the overall trend, in my opinion, will be to reduce the real rate of return that is a factor in interest rate levels today.

Mr. NOWAK. Let me just ask Mr. Edwards as counsel. One of the other points you made was a reflection of the credit being affected by the bankruptcy rate. Your consumer loans, I assume, have a greater default rate, and with all the exemptions that are written into the code, you are starting to feel a tremendous increase in the bankruptcies. What has been the experience?

Mr. EDWARDS. There has been a substantial increase. And it is easier. It used to be a social stigma to go into bankruptcy. The new act has tended to remove that. There are more people willing to avail themselves of relief under bankruptcy.

We are finding, especially after the act went into effect, that all over the country there was a substantial increase in bankruptcies. Banks had to factor that into their credit policies, and a lot of people who might have gotten loans under the old bankruptcy law simply fell out of the system at that time. They became too risky.

The resolution of bankruptcies in a lot of cases has taken a longer time. People can postpone repayment. And so the delinquency rate, particularly in bankruptcies, has gone up.

Some banks have experienced a situation where people who were up to date on payments—they weren't even late on payments—were in bankruptcy.

As unemployment has gone up there has been some influence on the bankruptcy rate. But having seen the bankruptcy rate increase and the exemptions increase, people can keep more of what they have. Having seen that happen when economic times are relatively good, we do have to feel that the liberalization of the bankruptcy law, as far as the debtors are concerned, has had an effect.

As Mr. Banta points out in his statement, you do have to factor that in when you are establishing the credit standards people must meet. So the Bankruptcy Act does have a definite influence.

Mr. NOWAK. As you know, the Judiciary Committee is looking at that now, and has had some hearings. I understand they are going to have more to look at. Possibly a markup to institute some of those changes.

Mr. Fary from Illinois.

Mr. FARY. Thank you, Mr. Chairman. Mr. Banta, in a deregulated environment where the banks are allowed to compete in an open financial service market, do you feel that adequacy of small business financing can still be maintained?

Mr. BANTA. Yes; I do.

Mr. FARY. Could you expound just a little bit on it?

Mr. BANTA. When you talk about open competition, are you talking about in the sense of source of funds—if I could just refine your question—or in the sense of interstate banking?

Mr. FARY. Either way.

Mr. BANTA. I think our testimony today dealt with the problems of sources of funding. Clearly if the banks do not retain their market share—and it has been pointed out earlier this morning that the banks are the single largest sources of financing of small business by some measure—ultimately, the flow of credit to small business will diminish. If the banks just don't have the same quantity of money relative to the total market why then clearly, unless someone assumes that role, the small business availability of credit will suffer.

From the standpoint of interstate banking, combinations of banks across State lines, whether it be large or small or medium was medium or small was small, I really don't think that will affect the credit availability to the small business. Because I think, one, it is already happening. In every small community they surely have customers or residents who also have funds in a money market fund. So it is happening already. The fact that banks could be larger in scale through interstate mergers would insure that in combination with the reg Q lifting, they could compete with these other sources. Whether they are within a State or across the State line, I don't think it would matter on that point.

Combinations of banks will surely lower costs. In today's tremendous cost and technological type of change or environment, the fact is that every bank cannot keep up with the computers and telephonic type of equipment. The larger operations, I think, will spread those costs and otherwise lower the cost of funds that they have to charge to their customers.

In the end, I don't really think the flow of credit will be curtailed. If there is a good credit worthy customer out there, the money will find it at a reasonable rate. That has always been the case. And I think it will be the case in the future.

Mr. FARY. Thank you very much.

Thank you, Mr. Chairman.

Mr. NOWAK. Thank you, Mr. Fary.

We have on the schedule this morning the Independent Bankers Association of America of the U.S. League of Savings Associations. And certainly, Mr. Banta, you are welcome to stay for that testimony.

I just wanted to again thank you for coming, realizing your schedule and looking at your involvement in the community generally. But more than that, the emphasis that your bank has placed upon trying to fulfill the credit requirements of many, many small businesses, businessess that I think are very necessary for the diversification in our own economy. I am sure I speak on behalf of many others.

Hopefully, you and I are going to find some way to remove some of the problems. And if we don't, I don't see how your institution or any other institution is going to be able to survive in this atmosphere. At the same time, what we are trying to do is bring about and create the atmosphere that we can get adequate dollars out in terms of numbers, and, of course, bring down the interest rate. Because I think no matter what else we do unless that does happen relatively shortly, we are going to have an unbearable stretchout of our whole economic problem that will be much longer than has been predicted by the administration.

Again, thank you for your testimony. We will have the record open in case we want to ask any future questions that develop.

Mr. BANTA. Thank you again. We appreciate the opportunity.

Mr. NOWAK. Thank you very much.

Our next witness is from the Independent Bankers Association of America, Mr. Robert L. McCormick, Jr. It is nice to see you again, Mr. McCormick.

Mr. McCormick is the president of the association. He is also president of Stillwater National Bank & Trust Co., Stillwater, Okla.

The IBAA is a national trade association of approximately 7,300 small- and medium-sized commercial banks.

It is a pleasure to have you before our committee again. Mr. McCormick did appear here when we were going through the interest rate hearings that we have had over the last 2 years. And we welcome you back before the committee. Your statement in total, Mr. McCormick, will certainly be inserted in the record.

TESTIMONY OF ROBERT L. McCORMICK, JR., PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. MCCORMICK. Thank you very much, Mr. Chairman. It's a pleasure for me to be here. I might want to add to your introductory remarks that my bank is about a $120 million bank, commercial bank, in Stillwater, Okla. Of the 7,300 small- and medium-sized commercial banks that we represent, some 90 percent of them are

less than $50 million in total assets. So essentially our entire association is comprised of small businesses. And one of the very significant features of our banking system is that we have about 10,000 banks that are small businesses interfacing with small businesses.

It is the only banking system in the world that is like that. And we have that system because of public policy. And if public policy did not mandate that we had a banking system comprised of thousands of small businesses interfacing with small businesses, it would not have happened, and it won't be true in the future. And that will be the essence of what I have to say today.

Slightly more than 2 years ago I appeared before you to discuss the impact of the then recently implemented change in the Federal Reserve's monetary policy, which looks toward better controlling of monetary aggregates rather than short-term interest rates. At that time, interest rates were at near record levels. I observed that the Fed's policy shift had created a situation in which banks were extremely uncertain about their cost of funds and hence could only lend on a short-term or variable-rate basis. The last 2 years have pretty well proven that out.

The rate of inflation has now declined dramatically, and the prevailing nominal interest rate have also dropped in that period. I think, as we said, when we look at the 16½ prime that we have today, we forget that it was over 20 at one time.

However, real interest rates—the difference between the inflation rate and long-term rates—have climbed to record levels. Long-term credit is largely unavailable, especially for small businesses. For the small business in need of capital, the very high price of available short-term funds is probably its No. 1 threat to survival. It cannot be tolerated indefinitely. At the same time, the percentage of so-called nonperforming or problem loans has increased for many banks. The banks, nevertheless, continue to meet the credit needs of troubled business customers and to reschedule debts, in the hope that interest rates will come down and the economy will recover in the future.

There are a number of factors contributing to the continued prevalence of very high interest rates. Federal fiscal policy continues to be expansionary and at war with the Federal Reserve policy, tending to keep interest rates high due to a combination of investor concerns over the future money supply growth and the future rate of inflation, continued high commercial loan demand, and the Government's continued massive participation in credit markets.

One of the things that I would point out from the discussion we had earlier with the subcommittee's majority staff member is, that after all, banks are only credit intermediaries. We buy money and resell it. And the rates of interest that we are charging reflect the rate that we pay. And I have some information with me, which you might want to talk about, which indicates that banks basically have the same profit margins today that they had 3 years ago. And so the determination of what interest rates will be is essentially set in the marketplace, and elsewhere, rather than in the corporate headquarters of banks.

Depositors have also become used to money market returns on their deposits. Banks with a marginal cost of 12 percent or

higher—and, as a matter of fact, average cost of funds in most banks are close to 12 percent at this time—must continue to charge high rates on loans regardless of the performance of the Consumer Price Index. The success of the anti-inflation effort has, ironically, played a role; thousands of businesses which made credit and spending plans in expectation of high inflation now find the unexpectedly sharp disinflation choking their cash flow and driving them into the short-term credit market, where that participation tends to bid rates up.

Finally, the continued growth and development of money market mutual funds, and other nonregulated financial services, has had an observable effect on the credit allocation system.

Something that I think is extremely significant is the way the SEC regulates the money market funds. They are prohibited from refunding those funds back into the small banks in this country. And when small banks have made efforts to cooperate or work with money market mutual funds in order to get that money back into their community, so they can relend it to small businesses and consumers, the SEC has blocked those efforts. As late as last week VISA was appealing the SEC's position, which would not allow them to operate a new money market mutual fund, and they were only proposing to refund money back into banks of $300 million or more, which would eliminate essentially 14,000 of the 15,000 banks in the country even at that level. So there is a very serious regulatory problem that we hope that Congress will address.

What does this recent troubling experience tell us about the relationships of small banks and small businesses? Small businesses are the recipient of about one-third of the $360 billion in business loans outstanding at commercial banks. Small- and medium-sized banks provide three-quarters of the commercial bank loans going to small businesses. The situation is mirrored in the agricultural sector where banks of less than $100 million in assets hold 70 percent of all commercial bank loans outstanding to farmers.

All of the available evidence indicates that smaller banks have continued to meet the credit needs of the 80 percent of small businesses which rely on depository institutions to meet their financing needs, especially during this period of unprecedented economic stress.

The report of the Interagency Task Force on Small Business, sent to Congress in February, could not find any evidence of a significant shortfall of funds available to small businesses relative to need. The task force also found that the relative ability of small businesses to obtain financing has improved steadily over two decades, and that banks are making a good faith effort to meet the credit needs of the small business customers during this difficult period. Three-quarters of the small businesses surveyed reported that banks were continuing to meet their credit needs.

Similarly, the President's March Report to Congress on the State of Small Business found remarkably, that from August 1980 to August 1981, the increase in rates for small loans and in rates charged by small banks has been much smaller than for large banks. In fact, a spread of about 2 percent for small loans over large loans during 1980 had disappeared completely by the end of 1981. This narrowed gap has helped stave off disaster for many

small businesses and is largely due to the fact that small bank deposits remain, to some extent, insulated from the national marketplace. Although some of the prophets of the new deregulation would cite this as inefficiency in the marketplace, it has operated to insulate small business and agriculture from the full fury of current interest rates.

This is most fortunate because most small firms have higher debt to equity ratios, than large firms, are more reliant on short-term debt, and are, thus, particularly sensitive to the disruptive impacts of lowered sales and other unfortunate symptoms of our business cycle.

Small business finance is of secondary importance to most of the Nation's largest banks. And it is instructive how they have behaved during this period. On Sunday, April 25, the New York Times featured a story on page 1 of its business section entitled, "How the banks are squeezing small business." It told of businesses cut off by their banks after a two-decade relationship because the profit potential of a $25,000 loan was deemed insignificant; of service charges being upped far beyond justification; and of loan officers being switched every 4 months, to a point where small business customers despaired of ever speaking to the same staff person twice, much less feeling that the bank understands their line of business and the value of their relationship. What we are speaking to here is that the relationship between small banks and small businesses is essentially personal in nature, and a personal relationship is very significant.

The article also told of small banks being swallowed up by larger banks, and of the changes that accompany this trend. One New Jersey businessman was quoted as lamenting, "It's not like it used to be. We've just become a number. The people who make the decisions are 20 miles away."

Now not every large bank is cutting off customers or hiking fees to the limit, and not every bank takeover results in a lessening of the bank-customer relationship. Nonetheless, if a business can be reduced to a mere number when its hometown bank is acquired by one up the road or over the hill, it would seem that we should be cautious about mandating a situation where the local bank is but one branch of hundreds of a money center institution located 1,000 miles or more away.

There are no economies in the processing of commercial loan applications. And if the local bank becomes part of an institution that has adopted a market strategy of mass producing financial services to large businesses and the upscale individual, then the local businesses, including the small farmer, may encounter increasing difficulty in fulfilling their credit needs.

I would like to respond to the testimony of the banker who testified before me in which he talked about economies of scale. All studies that I have read by the Federal Reserve—and they certainly are available to the committee—clearly indicate that there are no economies of scale related to total assets in the financial services industry. For one thing, small banks have access to all of the new technologies that are coming forward either by forming cooperative efforts or by receiving those services from vendors. My small bank is a member of a 105 bank ATM system that operates

all over the State of Oklahoma. My bank is on line. I operate by dumping the data directly into CRT's. Fully 35 percent of the tellers' transactions in my bank are handled by electronic transactions now. There are few, if any, large banks in the country that can match that record.

Let me observe at this point that the IBAA does not want to be on the record against all types of deregulation, because some can be very helpful. This would include a reduction in Government-mandated paperwork, the reexamination of laws which supposedly benefit the consumer but actually do little except drive up the cost and deluge him with reams of complex disclosure statements, and the authorization of competitive products by the DIDC so that banks can finally win back the customers from the nonregulated financial services institutions.

Bank examination practices might also be reviewed to see if they cannot better adapt to our business practices instead of the convenience of the supervisors—recent proposals to mandate accrual accounting for every bank in the country right down to $1 million, and to force banks which close one day midweek to nonetheless clear checks every weekday, fall into this category. Incidentally, those banks that close on Wednesday generally are open all day on Saturday for services to their customers.

Some legislative changes could also be helpful. A lifting of usury ceilings and remedial attention to the new Bankruptcy Act could increase the availability of credit to small businesses. The enactment of the regulators' bill in the form in which it passed the House, along with enactment of legislation to stabilize the troubled thrift industry, could help to shore up public confidence in the depository system while preserving its local bias. After all, the present savings and loan industry is essentially local in nature. They are community institutions organized by local citizens and operated for the benefit of the local community.

These are the types of initiatives which could be undertaken with beneficial results by the supervisory agencies and the Congress. However, there is another brand of self-styled deregulation which could be disastrous for this Nation and its small business sector. I am speaking of the calls for the economy of the United States to be dominated by a relative handful of all-purpose financial supermarkets; of proposals to endow thrift institutions with commercial banking powers so that they can fetch higher bids on the merger block, regardless of the effect on the tens of thousands of small businessmen called homebuilders; and of attacks on the McFadden Act and the Douglas amendment, neither of which regulates anything but both of which leave it to each State to determine whether out-of-State institutions can solicit deposits within its borders.

These proposals, all of which would result in a homogenized and vastly more concentrated financial world, could place small businesses on the short end of a very impersonal stick. Small businesses realize this. For example, the Indiana General Assembly just defeated a multibank holding company bill after a survey by the National Federation of Independent Businesses indicated that nearly 8 of 10 business owners were wary of the potential threat of large banks swallowing up the independent community banks.

Unfortunately, this administration continues to advocate policies which would further financial concentration. The President's own report to Congress foresees—

> A new environment where deposit funds will be collected by a large number of fairly good-sized financial institutions. . . . What is the prospect for small business financing in this environment? It is very likely that real interest rates will rise substantially for small borrowers in many small localities. . . . For the very small business borrower, the future is uncertain. The basic question is whether they will be able to bid successfully for higher cost funds.

The report goes on to say that—

> Many small business owners are concerned whether their financial needs will be met if small banks survive only as branches of larger banks.

Deregulation should be pursued where it can free up a market to serve an unmet demand. But small business is not demanding that large banks extend their branches to serve them.

On the contrary, the Interagency Task Force's survey of small business found that—

> More than two-thirds of the respondents believe that the size and location of a bank affects its willingness or ability to meet the respondent's credit needs. . . . More than two-fifths said they prefer to deal with a small bank, while another two-fifths prefer a small bank and less than one-fifth prefer a large one.

I'm not surprised by these results. I know that small businessmen want to deal with an institution that is based in the same community and is devoted to its prosperity; where a loan officer is likely to be there next year and the President is not fresh out of business school and devoted only to the short-term results so that he can move up the corporate ladder; and where he will be dealt with as a significant customer, and not as a minor and probably unprofitable applicant for funds. He wants to deal with officials who are willing to spend the time to learn his business needs.

In concluding, let me observe that total deregulation will probably never be possible or desirable in the financial services industry. Reserve requirements are necessary for the conduct of monetary policy. Deposit insurance has been the bedrock of the system's stability over the last half century, and as long as it persists, the Government must exercise some control over the conduct of financial affairs.

Aside from the risk to the insurance funds, the health of the financial system is so basic to the functioning of our Nation that its safety and soundness must be a public concern, and all proposals for deregulation must be examined with the greatest care and in the greatest detail.

We have all observed how airline deregulation has adversely affected service to many smaller communities and has permitted cutthroat competition and unbridled expansion.

Our Nation will undoubtedly survive the plight of the airlines and that industry will reorder its house in due course, although the ultimate value of its deregulation to travelers is still uncertain. But could we be so calm if we were not talking about a major airline's bankruptcy but that of a major money center bank which may be overextended internationally or otherwise, especially if a number of other financial institutions were also reporting massive financial hemorraging?

The financial system is so basic and vital that a degree of care must be addressed to any calls for restructuring. We must not forget that although it has its faults, the American banking system remains the envy of the rest of the world. One of the strengths of this system is that, with 15,000 banks in the country, if a few banks fail the whole country doesn't just tumble in after it.

Since regulation cannot be eliminated in the financial sphere, how can we best assure that what regulation exists is not unduly burdensome? The answer lies in the federal nature of our Republic, for the dual banking system fosters regulatory competition between State and Federal chartering agencies that results in a minimum of unjustified interference.

This same dual banking system gives each State the right to bar out-of-State depositories and thus preserve the local bias in its financial institutions. Any deregulatory proposal which damages the dual banking system should be regarded with the greatest skepticism, as it holds the potential to centralize all financial regulation in Washington and to concentrate financial power in a relative handful of distant, impersonal institutions. The result could be a dramatic constriction of small businesses' access to credit and the eventual stagnation of economic life in many of our communities as the stream of new jobs and ideas flowing from small businesses trickles to a halt.

Mr. Chairman, I will be glad to answer any questions you might have.

Mr. NOWAK. Thank you very much, Mr. McCormick, for the statement.

[Mr. McCormick's prepared statement follows:]

PREPARED STATEMENT OF ROBERT L. MCCORMICK, JR., PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Chairman and members of the Subcommittee, my name is Robert L. McCormick, Jr. I am the President of the Independent Bankers Association of America (IBAA), as well as President of the Stillwater National Bank and Trust Company located in Stillwater, Oklahoma. The IBAA is the national trade association of community banks, representing approximately 7,300 small and medium-sized commercial banks located in 48 states and the District of Columbia. IBAA member banks are primarily located in small towns and suburban communities and direct the major share of their commercial loans to small business and agriculture.

It is a pleasure for me to testify again before the Subcommittee. Slightly more than two years ago, I appeared before you to discuss the impact of the then recently implemented change in the Federal Reserve's monetary policy which looks towards better controlling the monetary aggregates rather than short-term interest rates. At that time, with interest rates at near-record levels, I observed that the Fed's policy shift had created a situation in which banks were extremely uncertain about their costs of funds and hence could only lend on a short-term or variable rate basis.

In the two subsequent years, the rate of inflation has declined dramatically; the prevailing nominal interest rate on loans has also dropped, but to a far lesser extent.

However, real interest rates--the difference between the inflation rate and the long-term loan rate--have climbed to record levels and long-term credit is largely unavailable. For the small business in need of capital, the very high price of available short-term funds is probably the number one threat to survival, and cannot be tolerated indefinitely. At the same time, the percentage of so-called non-performing or problem loans has increased for many banks; which nonetheless continue to meet the credit needs of troubled business customers and to reschedule debts, in the hope that interest rates will come down 3-4% and that the economy will recover.

There are a number of factors contributing to the continued prevalance of very high real interest rates. Federal fiscal policy continues to be expansionary and at war with the Federal Reserve's monetary policy, tending to keep interest rates high due to a combination of investor psychology, continued high commercial loan demand, and the government's continued, massive participation in credit markets. Depositors have also become used to money market returns on their deposits, and any bank with a marginal cost of twelve percent or higher for new funds must continue to charge high rates on loans, regardless of the performance of the Consumer Price Index. The success of the anti-inflation effort has, ironically, played a role; thousands of businesses which made credit and spending plans in expectation of

continued high inflation now find an unexpectedly sharp disinflation choking their cash flow and driving them into the short-term credit market, where their participation tends to bid rates up. Finally, the continued growth and development of money market mutual funds--and other non-regulated financial services--has had an observable effect upon the credit allocation system.

What does this recent troubling experience tell us about the relationship of small banks to small business?

This Subcommittee is already very much aware of the crucial role which small business plays in the American economy--as a creator of employment opportunities, particularly new jobs; as a generator of service and product innovations; as a contributor to the national wealth; and as the embodiment of our free enterprise system in providing an opportunity to that individual who has a better idea, and is willing to take risk, to bring his idea into the marketplace and reap the rewards of entrepreneurial success.

Small business is the recipient of about one-third of the $360 billion in business loans now outstanding from commercial banks. Small and medium sized banks provide three-quarters of the commercial bank loans going to small business; the situation is mirrored in the agricultural

sector, where banks of less than $100 million in assets hold seventy percent of all commercial bank loans outstanding to farmers.

All of the available evidence indicates that smaller banks have continued to meet the credit needs of the eighty percent of small businesses which rely on depository institutions to meet their financing needs, during this period of unprecedented economic stresses. The report of The Interagency Task Force on Small Business Finance, sent to Congress in February, could not find any evidence of a significant shortfall of funds available to small business relative to need, and also found that the relative ability of small business to obtain financing had improved steadily over two decades, and that banks were making a good faith effort to meet the credit needs of their small business customers during this difficult period. Three-quarters of the small businesses surveyed reported that banks were continuing to meet their credit needs.

Similarly, the President's March Report to Congress on "The State of Small Business" found, remarkably, that "from August 1980 to August 1981 . . . .the increase in rates for small loans and in rates charged by small banks has been much smaller. In fact, a spread of about two percent for small loans over large loans during 1980 has disappeared

during 1981." This narrowed gap has helped stave off disaster for many small businesses, and is largely due to the fact that small bank deposits remain, to some extent, insulated from the national marketplace. Although some of the prophets of the new deregulation would cite this as inefficiency in the marketplace, it has operated to insulate small business and agriculture from the full fury of current interest rates. This is most fortunate, because small firms have a higher debt/equity ratio than large firms, are more reliant on short-term debt, and are thus particularly sensitive to the disruptive impacts, lowered sales, and the other unfortunate symptoms of our current business cycle.

Although small business finance is of secondary importance to most of our nation's largest banks, it is instructive how they have behaved during this period. On Sunday, April 25th, the New York Times featured a story on page one of its Business Section entitled "How The Banks Are Squeezing Small Business." It told of businesses cut off by their banks after a two-decade relationship because the profit potential of a $25,000 loan was deemed insignificant; of service fees being upped far beyond justification; and of loan officers being switched every four months, to the point where small business customers despair of ever speaking to the same staff person twice, much less feeling that the bank understands

their line of business and values their relationship. The article also told of small banks being swallowed up by larger banks, and of the changes that accompany this trend. One New Jersey businessman was quoted as lamenting, "It's not like it used to be. We've just become a number. The people who make the decisions are twenty miles away."

Now not every large bank is cutting off customers or hiking fees to the limit, and not every bank takeover results in a lessening of the bank-customer relationship. Nonetheless, if a business can be reduced to a mere "number" when its hometown bank is acquired by another up the road and over the hill, it would seem that we should be cautious about mandating a situation where the local bank is but one branch of hundreds of a money center institution located a thousand miles or more away. The advocates of sudden and sweeping deregulation are quick to point out the economies of scale which are achievable in the deposit-taking function. But there are no similar economies in the processing of commercial loan applications, and if the local bank becomes part of an institution that has adopted a market strategy of mass producing financial services to large businesses and the upscale individual, then the local businesses (including the small farmer) may encounter increasing difficulty in fulfilling their credit needs.

Let me observe at this point that the IBAA does not want to be on the record against that type of deregulation which can be helpful. This would include a reduction in government-mandated paperwork, the reexamination of laws which supposedly benefit the consumer but actually do little except drive up costs and deluge him with reams of complex disclosure statements, and the authorization of competitive depository products by the DIDC so that banks can finally begin to win back customers from the nonregulated financial services institutions. Bank examination practices might also be reviewed to see if they cannot better adapt to our business practices instead of the convenience of the supervisors--recent proposals to mandate accrual accounting, and to force banks which close for one day mid-week to nonetheless clear checks each weekday, fall into this category.

Some legislative changes could also be helpful. A lifting of usury ceilings and remedial attention to the new Bankruptcy Act could increase the availability of credit to small businesses. The enactment of pending Export Trading Company legislation, provided it authorizes investment in trading companies by the bankers' banks organized to serve small banks, could do much to expand the disproportionately small share of export trade now held by small business. And the enactment of the Regulators' Bill in the form in which it passed the House, along with the enactment of legislation to stabilize the troubled thrift industry, could help to shore up public confidence in the depository system while preserving its local bias.

These are the types of initiatives which could be undertaken with beneficial results by the supervisory agencies and the Congress. However, there is another brand of self-styled deregulation which would be disastrous for this Nation and its small business sector. I am speaking of the calls for the economy of the United States to be dominated by a relative handful of all-purpose financial supermarkets; of proposals to endow thrift institutions with commercial banking powers so that they can fetch higher bids on the merger block, regardless of the effect on the tens of thousands of small businessmen called homebuilders; and of attacks on the McFadden Act and the Douglas Amendment, neither of which regulates anything but both of which leave it to each state to determine whether out-of-state institutions can solicit deposits within its borders.

These proposals, all of which would result in a homogenized and vastly more concentrated financial world, could place small business on the short end of a very impersonal stick. Small business realizes this. For example, the Indiana General Assembly just defeated a multibank holding company bill after a survey by the National Federation of Independent Business indicated that nearly 8 out of 10 small business owners were wary of the potential threat of large banks swallowing up independent community banks.

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Unfortunately, this Administration continues to advocate policies which would further financial concentration. The President's own Report to Congress foresees "a new environment where deposit funds will be collected by a large number of fairly good-sized financial institutions....What is the prospect for small business financing in this environment? It is very likely that real interest rates...will rise substantially for small borrowers in many small localities...For the very small business borrower, the future is uncertain. The basic question is whether they will be able to bid successfully for higher-cost funds."

The Report goes on to note that "many small business owners are concerned whether their financing needs will be met if small banks survive only as branches of larger banks." Deregulation should be pursued where it can free up the market to serve unmet demand. But small business is not demanding that large banks extend their branches to serve them. On the contrary, the Interagency Task Force's survey of small business found that "more than two-thirds of the respondents believe that the size and location of a bank affects its willingness or ability to meet the respondent's credit needs.... More than two-fifths said they prefer to deal with a local bank, while another two-fifths prefer a small bank and less than one-fifth a large one." (emphasis added)

I am not surprised by these results. I know that a small businessman wants to deal with an institution that is based in the same community and devoted to its prosperity; where the loan officer is likely to be there next year and the President is not fresh out of business school and devoted only to the type of short-term results that pave the way up the corporate ladder; and where he will be dealt with as a significant customer, and not as a minor and probably unprofitable supplicant for funds, by officials who are willing to spend the time to learn his business needs.

In concluding, let me observe that total deregulation will probably never be possible or desirable in the financial services industry. Reserve requirements are necessary for the conduct of monetary policy. Deposit insurance has been the bedrock of the system's stability over the last half centruy, and as long as it persists the government must exercise some control over the conduct of financial affairs. Aside from the risk to the insurance funds, the health of the financial system is so basic to the functioning of our Nation that its safety and soundness must be a public concern, and all proposals for deregulation must be examined with the greatest care and in the greatest detail. We have all observed how airline deregulation has adversely affected

service to many smaller communities and has permitted cut-throat competition and unbridled expansion which plunged Braniff into bankruptcy and brought several other major carriers face-to-face with that chasm of business ruin.

Our Nation will undoubtedly survive the plight of the airlines, and that industry will reorder its house in due course, although the ultimate value of its deregulation to travelers is still uncertain. But could we be so calm if we were not talking about a major airline's bankruptcy but that of a major money center bank which may be overextended internationally, especially if a number of other major financial institutions were also reporting massive fiscal hemorraging? The financial system is so basic and vital that an extra degree of care must be addressed to any calls for restructuring. We must not forget that, though it has faults, the American banking system remains the envy of the rest of the world.

Since regulation cannot be eliminated in the financial sphere, how can we best assure that what regulation exists is not unduly burdensome? The answer lies in the Federal nature of our Republic, for the dual banking system fosters regulatory competition between state and Federal chartering agencies that results in a minimum of unjustified interference.

This same dual banking system gives each state the right to bar out-of-state depositories and thus preserve a local bias in its financial institutions. Any deregulatory proposal which damages the dual banking system should be regarded with the greatest skepticism, as it holds the potential to centralize all financial regulation in Washington and to concentrate financial power in a relative handful of distant, impersonal institutions. The result could be a dramatic constriction of small business' access to capital, and the eventual stagnation of economic life in many of our communities as the stream of new jobs and ideas flowing from small business halts to a trickle.

Mr. NOWAK. We have a quorum call of the House, and we will have to recess this for approximately 10 minutes to answer that quorum call. We will be right back.

[Recess.]

Mr. NOWAK. We will continue the questioning at this time.

But let me ask a couple of questions. You had mentioned in your testimony and I think in your general remarks that 7,300 banks that you represent are really small businesses themselves. I think that's an overlooked reality, and if that is true, certainly we are not going to have the same structure to work with. I think there is some real validity in the assertion that unless you know the person you are dealing with rather well, especially if you're a small business with unaudited statements, you have got one very difficult position to bargain with.

The other statement you made relating to the margins kind of goes to Mr. Centner's statement too about the variation between what the inflation rate is and what the real interest rate is. You said that banks, in general, have been stuck with a margin that has not increased greatly. I wonder if you could expand upon that because I think the perception is that bankers have reaped a great benefit from the rise in interest rates. With your cost of money at approximately 12 percent, I would think that's the only area of growth that you are ever going to look forward to now.

Under the new structure that we talked about and the competition that you have with the money markets, if you can get money at 5¼ percent, you are a better salesman than that guy selling snake oil, I guess.

Could you go through that, Mr. McCormick?

Mr. MCCORMICK. Yes, I certainly would. I think that the banking industry is clear on this. And we are very anxious to convey this to the Congress. High interest rates are very damaging to the banking industry, because after all, a bank cannot be stronger than its customers. And if I have a bunch of small businesses out there that I am lending money to and they are all getting clobbered because of

economic conditions and high interest rates, well, then I cannot run a strong and successful financial institution. Because the strength and success of my financial institution is going to be the total success and strength of each customer I have, both borrower and depositor.

Having said that, I can go on and say that we as bankers, of course, are buyers and sellers of money. The rate at which we sell money is largely dictated by the rate at which we have to pay for it. In addition to that, the current prices or what you call the marginal prices of funds, i.e., what I am bidding for funds on any given day, versus what I am selling funds on any given day are only part of the overall financial picture for a financial institution.

For example, in 1981 Stillwater National Bank and Trust Co. had an average yield on loans of 15.02 percent. Now the prime probably at that time was about 17½. But the average yield of all the loans I had in the bank were only 15.02.

For all banks in the United States from $100 to $300 million, the average yield on all loans were 14.78. That is the average yield on all loans for the year of 1981. Our average cost of interest bearing funds for my bank was 11.73. And for all banks in my peer group, it was 11.59. OK. So my bank had a margin of 3.29. That's the difference between the average cost of yield on loans and the cost of all interest bearing funds. The peer group had a margin of 3.19. So in 1981, which was a period in which we had very high interest rates and I think there was a perception maybe by some people in Congress and by the public at large that banks were privateering on rates, my margin rate was 3.29. All banks in my size group averaged 3.19.

Now I can add to that the following information: In 1980, the margin for all banks in my size group was 3.37, slightly more than either one of those margins in 1981. In 1979, the margin was 3.16 for all banks in my peer group. I can go back and give you 1978 and 1977 but it would take me a minute to figure it out.

But I think that the results would be essentially the same. The margin has not changed that much. And we are pricing our product based on what we think we have to do in order to cover our costs and make a reasonable return for our shareholders. So when you want to talk about the level of interest rates, you have to talk about the things you have been talking about because they all influence it. But the most important determinant is the cost of funds to the lender. Those funds are determined by the marketplace. And the biggest player in the marketplace is the Federal Government. When the Federal Government goes into the marketplace, they borrow their funds first. They always get their money. And then once they have paid whatever price the marketplace determines they have to pay to get their money, then the rest of the world has to bid more in price to get theirs.

So it's really the competition in the marketplace for funds that is determining what the rate is today.

Mr. NOWAK. So the deficit has some meaning in the whole scheme of things. Some of the supply side economists now say that we don't have to put the emphasis on the deficit anymore, we put the emphasis on the incentives and the deficit will take care of itself down the road.

Mr. McCORMICK. I think theoretically that the supply side approach makes a lot of sense. But it has to be applied in a pragmatic way. I believe that we feel that it has been applied in sort of a doctrinare way and completely across the board. And because of that, there is a great deal of suffering in the economy that is not really necessary.

I think the banking industry and certainly our association would endorse the concept of reducing Government expenditures as a percentage of the gross national product. And would endorse the concept that encouraging a profitable private enterprise in order to increase tax collections is a good strategy. But maybe the specific way we are going about it hasn't worked out.

Mr. NOWAK. Well the other side of that coin, of course, is the monetarist point of view which I guess you could associate with former heads of Treasury such as Greenspan and Simon who emphasized the other side of the coin to control the deficit by controlling Federal spending. It is somewhat more moderate on the need for large tax cuts to go in through the system immediately and the adjustment of those two things are the conflicts that the present administration is struggling with. On the one hand we have postponed the tax cut, and that upset the supply side people. And on the other hand, the monetarists certainly haven't got the kind of cuts that they were looking for to signal the psychology to change in the country. It is a continuing point of confusion upon many. When you look at individual specifics, in and by themselves, it is easy to say, yes, we should cut taxes, yes, we should cut spending as a group. But when you look at the specifics, you see some real crumbling of that kind of support. And it comes from the administration as well as the Members of the Congress, especially the Senate.

Mr. McCORMICK. Mr. Chairman, if I may respond to that. I think also that the banking industry and certainly our association very strongly believes in a balanced budget. Not only balance the budget, but to state and have a clear policy that we will balance the budget going forward. And it should be the policy of this country to operate under very close to a balanced budget year end and year out.

If we were to do that by whatever means, then I think you would have a dramatic drop in interest rates, and businessmen could begin to plan for the future. It is almost impossible today to have 5-year plans, 10-year plans, 3-year plans, or 6-month plans. It is extremely difficult to have today because nobody knows what the level of economic activity will be, we don't know what interest rates are going to be, we don't really know anything about the future. And it has put one hell of a damper on the economy.

Mr. NOWAK. The problem is that while we go through the reductions here, people are going to invest their money where they are going to get the highest possible return with the lowest possible risk.

When you look at the whole economy and say, yes, we have put some incentives on—you have increased the appreciations allowances. You can go out and buy a building today, and as I figure out the accelerated appreciation in my own mind I come up with about 11.666 or 7 percent that you can take. In 5 years, this is an un-

heard of figure. But why isn't everybody building? Why isn't everybody investing? We have to look at the other side of that equation. If the demand is not equal to production, production is going to wane. We have seen the manufacturing sector today going back to 67 or 68 percent in many industries. And if you are at that level, and despite the incentives we put in, the demand for that product, for one reason or another, is gone. Some of the demand is dampened by the interest rate. Some of the demand is dampened by the price of the item itself. If we can force through the system more incentives on the supply side with the depreciation investment tax credit and other incentives, the system will deliver and more and more people will work.

But if that basic product demand isn't out there or if there are inventory problems, whatever we did last year doesn't seem to have that effect because we have got to balance the increase in production with the demand. You can't falsify that whole free market system. It will operate by itself.

And a big part of that, I guess, is this interest rate which dampens the demand. I am just very fearful that if we don't get that interest rate down, the demand won't be increasing. And if the demand doesn't increase, certainly production won't increase. Nobody is going to invest to build more of anything if the market isn't there for them to sell it. And if their capacities are 60–70, they are going to wait until they are back up to 85 before they reinvest into new equipment and new products.

How do we adjust all of this from the viewpoint of the interest rate? You know we say that if we bring down the deficit—as Rick mentioned, there are all kinds of statistics that show we had great growth in periods where the deficit was much higher as a percentage of the gross national product. As you know, we had the opposite reaction. Inflation was down, unemployment was up. It is such a mix out there it is difficult to try to focus in onto one policy.

The view that I am coming around to is that in the last year and a half we have really had a structural change that is going to be with us from now on. We are moving into pure competition in the financial markets, and we haven't even really felt the impact of that yet.

We are just in the beginning stages. You mentioned, Mr. McCormick, that the weight of deficit and Government borrowing starts that cycle. But isn't the cycle increased in terms of its force when you have savers going from the banking institutions to the money market funds? If you have got to compete with them, your margins aren't any different. If they are not any different, you are not making any more money despite the fact that everybody believes you are making a killing because of high interest rates.

This money market change, I think, is a different structure in and by itself that is going to be awful hard to compensate for and to assimilate in the whole system. And it is going to take us a much longer time to do that.

In the meantime, you are facing total deregulation in your industry. You have got the interest rate problem, you have got the money market competition, and now you are going to have competition from some of the new financial "supermarkets." I assume that it is not going to be the banks that are going to be your com-

petition. I assume it is going to be Sears and others. If you have got a plaza with a Sears store, that is where your competition is going to come from in the next year or two as this total deregulation goes through. I wonder if you could comment on that. I'm sorry I rambled on.

Mr. McCORMICK. Well, I certainly can. I guess maybe the last first. The competition from people like Sears and Roebuck, of course, will be very strong. But I think we are fairly clear that if we were allowed to compete and pay money market rates for funds, then Sears would carve out a small piece of our market and we would all compete and go on.

But if the banking business is left with an inability to compete with companies like Sears, well, we are really going to be strapped. And it is going to be hard on us. And Sears will not refund the funds back into our market and lend money to our customers. That's not the way they are organized.

Further, as far as—I don't know whether to call it getting the interest rates down or getting the country going or what have you—but again I think I have got to emphasize that we have got to have some sort of long-term program that gives people confidence in what is going on.

You talked about that buildings aren't being built like you would expect them to because of depreciation. Well, when you go and borrow money to build a building today, you don't know what the interest rate is going to be in the future. No one is willing to contractually commit that because of the instability that we have had. And if you try to lease the building nobody will lease the building today for a set price, anymore. You get a floating square foot charge that is going to be indexed to the price index or to the cost of operating the building or something else. All those unknowns cut an awful lot of people out of the marketplace.

If I were going to rent a building today in a modern office building, I am going to have to have one heck of a factor in there for what my rent might be in 2 or 3 years because I can't tie that down today. You can just take that and carry it to every financial decision that has to be made in the economy. It is having a devastating effect.

Mr. NOWAK. But if we acknowledge the structure has changed, that is going to be the modus operandi forever now. Plus, you are going to get the competition from the banks. What stability we had was provided by 30 year mortgages at a rate of 8½ or 10 percent. If that is gone, all the leases that are out there, when they are rewritten, and all the new leasing—I think you are right. This causes the instability. Where else is it coming from?

Mr. McCORMICK. Well, I think it comes from national economic policy as a combination of what the Federal Government is doing in financing its activities and what the Federal Reserve is doing in response to them. And until the two institutions get together and come out with a long-term program that encourages economic stability and a certain rationalization of what is going on over an extended period of time, it is not going to be changed.

I don't think, for example, a reinstitution of a regulation Q or a Government mandated interest rate on both the wholesale and retail level or anything like that would get the job done because

you would have other inefficiencies that would develop in the economy as a result of the regulation that you went to.

Mr. NOWAK. The long-term guarantee, deficits or anything else, probably could not be instituted unless you had a constitutional convention.

Mr. MCCORMICK. I'm not talking about constitutional amendments. I'm really talking about trust level. Trust level is a very difficult thing to obtain. Bankers are very sensitive to it. We know that we have got to have a high trust level with our customer because he comes in and gives us our money and he believes we are going to give it back to him when he comes back and asks for it. And if we price a loan that it is a fair price, and what have you.

Well, the Government and the economy has a trust level problem. And you have to address that on a number of different levels. I am not qualified to tell you what all the levels are, but until we reestablish a trust level, I think we are faced with a problem.

Mr. NOWAK. Well, I appreciate your testimony and for taking the time to prepare a very complete statement. And I think your statement does express a concern of the small business sector of our economy—your own banks. You are certainly to be congratulated for putting forth that effort, and we certainly will try to bring your testimony to as many members as we can, not only of this committee but of the Congress.

We have another vote on the floor in a couple of minutes.

Again, thank you very much for your statement.

Mr. MCCORMICK. Thank you very much, Mr. Chairman.

Mr. NOWAK. Thank you.

We will recess again for 10 minutes and then we will have our last witness, the U.S. League of Savings Associations, testify. Hopefully, we will get you out so that you can have your lunch. Be right back.

[Recess.]

Mr. NOWAK. The next witness will be for the U.S. League of Savings Associations, Mr. Howard T. Glover. Do you want to come forward, Mr. Glover?

Mr. Glover is the chairman of the league's Committee on Development for Smaller Associations. He's also president of Conneaut Savings and Loan Co. We appreciate your patience. Your complete statement will be inserted into the record, and I will let you proceed.

TESTIMONY OF HOWARD T. GLOVER, CHAIRMAN, COMMITTEE ON DEVELOPMENT FOR SMALLER ASSOCIATIONS, U.S. LEAGUE OF SAVINGS ASSOCIATIONS

Mr. GLOVER. Thank you, Mr. Chairman. I am here today as a representative of the U.S. League of Savings Associations which I serve as the chairman of the Committee for Development of Smaller Associations. And also I am president of the $40 million Conneaut Savings and Loan Co. in Conneaut, Ohio.

Speaking for the savings and loan industry as a whole, the conduct of the deregulation of depository institutions has been nothing short of a disaster, and not just for our institutions, but for the

home builders, realtors, and home buyers which rely upon us for mortgage credit.

This is not to say that we oppose deregulation. Quite to the contrary, we welcome it. What we do oppose is unbalanced deregulation. Unbalanced deregulation in an era of high and volatile interest rates has brought about our economic problems. Deregulation actually began for us in 1978 when the very popular 6-month money market certificate or MMC was authorized carrying Wall Street money market rates.

Unfortunately, market adjusting savings accounts could not be matched with regulated assets. Our mortgage portfolios are filled with old fixed-rate long-term loans. In a time of escalating interest rates, the yield on our loans cannot begin to meet the public's demand for market rates on deposits.

Between June of 1978 when the MMC was authorized and March of this year, the average cost of funds to savings and loan associations rose from 6.61 percent to 11.34 percent, an increase of 473 basis points.

Meanwhile, loan mortgage portfolio yield went from 8.49 percent to 10.17 percent, up only 168 basis points. That translated in March to a negative earnings spread of 117 basis points for the industry as a whole. In my own particular company, that spread is a minus 127 basis points at this time.

If, however, adjustable rate mortgages had been authorized simultaneously with the introduction of MMC's, savings associations' portfolio yields could have been 160 basis points higher than they actually were. And we could be operating today with positive earnings spreads.

Mortgage credit would be more readily available, though we, too, recognize that today's rates are far too high for many family budgets. Housing starts might not have reached near depression levels, and realtors would not be out of work. In short, unbalanced deregulation has contributed in large measure to our problems.

Savings side deregulation really developed a head of steam with the passage of the 1980 Depository Institutions Deregulation and Monetary Control Act. And the subsequent establishment of the Depository Institutions Deregulation Committee or DIDC. First, the DIDC raised interest ceilings on MMC's and on 30 month small saver certificates. In the process, it effectively eliminated the housing differential on MMC's.

Then after that, it removed the 12-percent cap on the 30 month small saver certificate rate, locking us, again, into the high-rate, long-term money.

Last September, the DIDC voted to increase passbook rates by 50 basis points, and removed all rate ceilings on Keogh and Individual Retirement Accounts. Only after pressure from the House and Senate leadership and the House and Senate Banking Committees' membership did the DIDC reverse itself on the passbook increase. Just 2 months ago, the deregulators approved a deregulation schedule beginning with the new 3½ year, ceiling-free certificates which phases out all rate ceilings by March 31, 1986. The courts had struck down an earlier phase out plan.

Also approved was a new 91-day account with, I am pleased to say, a rate differential. There are reports that the DIDC is still not

satisfied and wants to deregulate by inventing still another short-term deposit certificate with a minimum requirement of somewhere between $10,000 and $25,000. Reportedly, this certificate would carry no interest rate ceiling and would have only a very short withdrawal notification requirement. An account of this sort would be yet another one which thrift institutions will be hard pressed to afford.

Unfortunately, we will be even more hard pressed to ignore it if we are to avoid losing still more deposits, funds needed for lending.

Commercial banks, as you know, have far greater asset flexibility than do thrift institutions, both in terms of variety and in the ability to respond to market movements. Generally speaking, the requirement has been that 80 percent of our portfolios be devoted to housing finance. How have the much more flexible commercial banks fared during deregulation? Last year, commercial banks reported record earnings levels with return on assets at a plus 0.98 percent. Our return on assets plunged to a minus 0.93 percent.

The reason, very clearly, is commercial banks in the aggregate had in place in 1978 the investment flexibility that is necessary for depositories to operate profitably in a deregulated, high interest rate environment. I should note, however, that many smaller rural and community banks, which, like thrifts, have sizable fixed-rate loan portfolios, share our earnings handicaps.

Three bills now pending in Congress would provide thrifts with the broader lender flexibility they so urgently need. They are H.R. 4724, sponsored by Congressman Stanton; and S. 1703 and S. 1720, sponsored by Senate Banking Chairman Garn.

If I may, I would like to make a personal observation here of my own home market area, Conneaut, Ohio. Until recent years, we had three locally owned commercial banks in our community. Today, we have none. They have been converted to branches of giant banking combines headquartered from 75 to 200 miles away. Management has changed drastically in those banks, and loan policies have gotten tougher.

Small businessmen in my community have come to me and expressed concern to me that they no longer have a commercial banker who is local, who understands their needs, and the needs of the community.

The bills I just mentioned would permit us to make commercial, corporate, business and agricultural loans, and to offer demand or checking accounts. Further, they would remove restrictions which apply on real property loans, including the 20 percent of assets restrictions we now have on investment in small business and commercial properties.

Though it is not included in these bills, the U.S. League is further recommending that savings associations be granted authority for direct equity investment in real estate.

These proposals all look to the future. Short-term assistance is urgently needed as well if we are to continue to function. The House Banking Committee has reported out H.R. 6267, Chairman St Germain's Net Worth Guarantee Act, which would provide capital assistance to thrift institutions, commercial banks and credit unions whose net worth ratios have fallen below 2 percent of assets.

I should point out that this legislation carries no direct Federal budget outlay, and, therefore, does not affect the deficit, which seems to preoccupy those on Wall Street who determine the level of interest rates generally.

I hope the members of this distinguished subcommittee will add their support to H.R. 6267 when it is brought to a vote on the House floor, perhaps by the end of this week.

The picture I have painted of savings and loan associations in a deregulation climate is not an optimistic one, I grant you. But we remain optimistic so long as there are Members of Congress who understand and appreciate the destructive nature of mismanaged deregulation.

As I said at the outset, we are not opposed to deregulation, but it must be balanced. We have suffered and our communities have suffered as a result of unbalanced deregulation.

This Congress has an opportunity to correct that imbalance and to insure that the thrift industry is armed with sufficient new lending powers to reestablish it as this Nation's most reliable source of housing finance, as well as a significant new source of capital for the small businessmen and women.

I'd like to conclude my remarks by just commenting on Mr. Dorgan's opening remarks and remarks of Mr. McCormick.

I am a strong advocate and a believer in that there is a place and a need for the small local financial institution, whether it be a commercial bank, savings and loan, credit union, or whatever it is. And that there is a need that can be met and fulfilled that may not be met by a large, major metropolitan city bank.

If a $12 billion or $20 billion or $30 billion bank or savings and loan company came into the area, we would still be able to compete very well as a small association if we were able and willing to accept the new changes and recognize the fact that we are operating in a highly different type of industry than we have been in the past. And I think most of us who are willing to accept that will be able to survive during this critical period that we are going through.

Thank you, Mr. Chairman.

Mr. NOWAK. Thank you very much.

[Mr. Glover's prepared statement with attachments follow:]

PREPARED STATEMENT OF HOWARD T. GLOVER, CHAIRMAN, COMMITTEE ON DEVELOPMENT FOR SMALLER ASSOCIATIONS, U.S. LEAGUE OF SAVINGS ASSOCIATIONS

Before the
House Tax, Access to Equity Capital and Business Opportunities
Subcommittee

of the
House Small Business Committee
Washington, D. C.
May 19, 1982

Thank you, Mr. Chairman, and members of this Subcommittee. My name is Howard T. Glover, and I am President of Conneaut Savings and Loan Company of Conneaut, Ohio. I am here today as a representative of the U.S. League of Savings Associations*, which I serve as Chairman of the Committee on Development for Smaller Associations.

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*The U.S. League of Savings Associations has a membership of 4,100 savings and loan associations representing over 99% of the assets of the $650 billion savings and loan business. League membership includes all types of associations -- Federal and state-chartered, stock and mutual. The principal officers are: Roy Green, Chairman, Jacksonville, FL; Leonard Shane, Vice Chairman, Huntington Beach, CA; Stuart Davis, Legislative Chairman, Beverly Hills, CA; William O'Connell, President, Chicago, IL; Arthur Edgeworth, Director, Washington Operations; Glen Troop, Legislative Director; and Phil Gasteyer, Associate Director, Washington Operations. League headquarters are at 111 East Wacker Drive, Chicago, IL 60601. The Washington Office is located at 1709 New York Avenue, NW., Washington, D.C. 20006. Telephone: (202) 637-8900.

We appreciate this opportunity to provide our industry's view of the impact of banking deregulation on small businesses. Speaking for the savings and loan industry as a whole, I will spare you from suspense and state at the outset that the conduct of the deregulation of depository institutions has been nothing short of a disaster -- and not just for lending institutions, but for the small businesses which rely upon them as well.

This is not to say that we oppose deregulation. Quite to the contrary, we welcome it. What we do oppose is unbalanced deregulation. And it is precisely this imbalance in deregulation implementation in an era of high interest rate volatility that has brought about the economic stress being experienced today by thrift institutions nationwide.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (H.R. 4986, PL 96-221) is the principal banking deregulation statute now on the books. But deregulation actually began two years before when, in 1978, the very popular six-month Money Market Certificate (MMC) was authorized. Rates on the MMC are tied to the yield on six-month U.S. Treasury obligations, which are set each Monday afternoon at auction.

The introduction of this savings instrument provided consumers with an opportunity to earn market rates on deposits. It provided depository institutions with the first major threat to their earnings potential. For, while deregulators were tinkering with the liability or deposit side

of our ledgers, they totally ignored the obvious need to provide flexibility on the asset or lending side.

What was needed and what should have been implemented well in advance of the introduction of MMCs was a truly flexible mortgage instrument -- one whose yield would rise and fall with the market, just as yields on MMCs rise and fall with the market. We knew that deposit interest rate deregulation would some day be a reality, and as early as 1973 the U.S. League was advocating variable rate mortgages. In 1975, the Federal Home Loan Bank Board proposed rules which would have allowed variable rate mortgages. But the Congress, through a House-passed bill and a Senate resolution opposing them, forced the regulators to withdraw those rules. It was not until April of 1981 -- nearly three years after the introduction of MMCs -- that a truly workable variable rate mortgage instrument was made available to Federally-chartered savings and loan associations. (Though the situation varies from State-to-State, adjustable-rate loans, were similarly denied State-chartered companies in most jurisdictions.)

Through their unbalanced approach, deregulators sentenced depository institutions to an indeterminate term of declining net worth. Old, low-yielding, long-term and unsaleable mortgages overpopulated institutions' portfolios. In a time of escalating interest rates, their yield could not begin to meet the public's demand for market rates on deposits.

Between June 1978, when the MMC was authorized, and March of this year, the average cost of funds to savings and loan

associations rose from 6.61% to 11.34% -- an increase of 473 basis points. Yet the yield on portfolio, encumbered by those old, low-yielding mortgages, increased by only 168 basis points in the nearly four years since deregulation began in earnest.

Portfolio yield went from 8.49% in June of 1978 to 10.17% this past March. In this period of unbalanced deregulation, we have seen portfolio yield increase by just 19.8%, while our institutions' average cost of funds has risen by 71.6%. The result has been that savings and loan associations in March of this year operated with a negative earnings spread of 117 basis points.

Perhaps the most vivid illustration of unbalanced deregulation's cost is the fact that if adjustable rate mortgages had been authorized simultaneously with the introduction of MMCs in 1978, savings association portfolio yields could have been 11.77% in March of this year -- 160 basis points higher than they actually were. Consequently, savings associations would be operating today with positive earnings spreads of 0.43%. Mortgage credit would be more readily available -- though we too recognize that today's rates are far too high for many family budgets. Carpenters, plumbers, landscapers, plasterers and bricklayers would be working. Lumber yards, furniture and appliance manufacturers, real estate firms would be in better shape. Housing starts might not have reached near-depression levels. In short, unbalanced deregulation has contributed in large measure to the most serious economic recession this nation is enduring today.

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Thus far I have spoken only of the six-month MMC, which was in place before the 1980 Depository Institutions Deregulation and Monetary Control Act was signed into law. Savings-side deregulation really developed a head of steam with the passage of that law and the subsequent establishment of the Depository Institutions Deregulation Committee (DIDC).* Among the DIDC's Congressional mandates is the task of eliminating savings rate controls (known by the shorthand "Regulation Q") by March 1, 1986. Reg Q provides that thrift institutions, because of their mortgage-lending specialty, may offer consumers 25 basis points more than commercial banks to attract savings deposits. This quarter-point advantage traditionally has been known as the "housing differential."

Before the DIDC held its first meeting on May 6, 1980, the liability side of the savings and loan business already had been deregulated significantly. Despite this, the business maintained a modest positive earnings position and deposit inflows in the face of a prolonged period of high interest rates. But this positive spread was only 0.17% in the first half of 1980, the worst six-months earnings performance for the business since the 1930s.

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*The DIDC is comprised of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Chairman of the Federal Home Loan Bank Board, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the National Credit Union Administration and the Comptroller of the Currency. It is interesting to note that while the National Credit Union Administration Chairman is a voting DIDC member, credit unions are not bound by DIDC actions. The Comptroller of the Currency is a non-voting member.

Despite this weakened condition, the DIDC plunged ahead with additional deregulation activities, ignoring the DIDMC Act's direction that due regard be given to the safety and soundness of thrift institutions. At its very first meeting, the DIDC raised ceilings on MMCs by 25 basis points, and on 30-month Small Saver Certificates (SSCs) by 50 basis points. Further, the DIDC created new minimum ceilings for MMCs and SSCs, and in the process, effectively eliminated the housing differential.

The DIDC's next major action was taken on June 25, 1981, at a time when the condition of thrift institutions clearly had deteriorated further. By June 1981, roughly 70 percent of all associations were operating in the red and record deposit outflows were being reported nationwide.

With full knowledge of this most serious condition within the business, the DIDC further accelerated the deregulation process by removing a 12% cap on the 30-month Small Savers Certificates rates which the DIDC had established one year before, thereby further increasing thrift institutions' costs. Even more significant, the DIDC proposed removing all interest rate ceilings on certificates with maturities of four years or more. Only through court action, which proved conclusively that the DIDC was acting outside its Congressional mandate, was this later action nullified.

Still more destructive actions were to be taken by the DIDC. At its September 22, 1981 meeting, the DIDC voted to increase passbook rates by 50 basis points, authorized a new

four-week averaging process for computing MMC ceilings at higher levels, and removed all rate ceilings on Keogh and Individual Retirement Accounts. Only after pressure from the House and Senate leadership and the House and Senate Banking Committees' membership did the DIDC reverse itself on the passbook increase -- which, unlike time deposits and certificates, promised an instantaneous "hit" to the bottom line and offered no prospect of new customers. The other actions were not changed, however, and are in force today.

At the DIDC's March 22, 1982, meeting, the deregulators created a 91-day savings account indexed to the 91-day Treasury bill rate. Recognizing the severe deposit drain on thrift institutions, a quarter-point housing differential was attached. Also approved was a deregulation schedule beginning with a new 3-1/2-year, ceiling-free certificate. The schedule directs that on April 1, 1983, ceilings on 30-month accounts will be lifted. The schedule further directs that account ceilings will be lifted beginning April 1, 1983 on 30-month accounts; April 1, 1984 on all 18-month accounts; and April 1, 1985 on all six-month accounts. Finally on March 31, 1986 all remaining accounts will be without a ceiling rate.

Next Monday, May 24, the DIDC is scheduled to meet again. They are reported to be ready to approve a new, short-term deposit certificate with a minimum deposit requirement of somewhere in the range of $10,000 to $25,000. This certificate would carry no interest rate ceiling and would have only a very short (7 to 14 days) withdrawal notification requirement. This high-cost

account is yet another one which thrift institutions will be hard-pressed to afford. Unfortunately, they will be even more hard-pressed to ignore it if they are to avoid losing still more deposits -- funds needed for lending to home buyers.

Commercial banks, as you know, have far greater asset flexibility than do thrift institutions. Thrifts for years have been restricted by the "banking," and to some extent, the tax laws, in the composition of their investment portfolios. Generally speaking, the requirement has been that 80% of our portfolios be devoted to housing finance.

How have the much more flexible commercial banks fared during this deregulation period? In 1978, the year deregulation really began, insured savings associations had a return on assets of 0.84%, as compared to 0.76% at commercial banks. That was our last good year. In 1979, our return on assets fell to 0.68% while the return for commercial banks rose to 0.81%. The year 1980 saw our return on assets plummet to 0.13%, and commercial banks' return moved to 0.80%. Last year commercial banks reported record earnings levels with return on assets soaring to 0.98%. Our return on assets plunged to a minus 0.93%. (See Exhibit 1)

Is this because commercial bankers are so much smarter than thrift institutions managers? Of course it is not. The reason very clearly is that commercial banks had in place in 1978 the asset-side or investment flexibility that is necessary for depositories to operate profitably in a deregulated, high-interest-rate

environment. Thrift institutions did not have that flexibility when deregulation began, and they have precious little more of it today.

Back to our fellow small businessmen and small businesswomen. How are they faring with the commercial bankers? Not well, according to many reports I have read. Attached to my statement for inclusion in the record is an article from the New York Times of Sunday, April 25, 1982 (see Exhibit 2), from which I here quote in part:

"'If we borrow, it's two or three percentage points above the prime rate, while big companies borrow well below the prime,' said Wiley J. Pickett, owner of the $500,000 company (Utility Industries of Somerdale, N.J.), which makes devices to pull cables through conduits. 'Not that I'm complaining about what big business gets. It's what small business doesn't get,' Mr. Pickett added.

"Then there's the kind of experience of another small company, Accurate Inventory Services in New York recounts. The company, which does inventory accounting for client retailers, had been doing business with the Chase Manhattan Bank for almost 20 years. But then Chase told the company to take its business elsewhere.

"'They said they couldn't make enough money on a $25,000 loan,' said Arnold S. Gerber, the Accurate Inventory's president. 'They made no bones about it, they literally told me to go to another bank,' Mr. Gerber said."

Similar experiences are mentioned throughout the article, which I believe serves to underscore a second reason for the need to provide thrift institutions with new asset-side flexibility. Thrift institutions must have broader lending powers in order to meet consumer demand for market interest rates on deposits. They need it as well as to meet their communities' general borrowing needs -- needs apparently being ignored or going unsatisfied by large commercial banks -- while continuing their traditional role as housing finance specialists.

Three bills now pending in this Congress would accomplish this. They are H.R. 4724, sponsored by Rep. J. William Stanton and S. 1703 and S. 1720, sponsored by Senate Banking Chairman Jake Garn. These bills contain the broader lending powers that thrift institutions and small business entities so desperately need.

In their various forms, these bills would permit us to make commercial, corporate, business and agricultural loans -- secured or unsecured. (The same loan-to-one-borrower limitations as required now of commercial banks would apply.) These bills also would provide us with authority to offer demand or checking accounts to any customer, be it an individual, a non-profit institution or a business entity.

Further, these bills would remove restrictions which now apply on real property loans, including the 20%-of-assets restriction we now have on investment in small business and commercial properties. They would provide authority to invest

in tangible personal property, thus offering the potential for some consumer and commercial equipment leasing. Asset limitations on municipal and corporate debt and commercial paper investment would be removed. We would be permitted to engage in "floor plan" financing of dealer inventories.

Though it is not included in these bills, the U.S. League is further recommending that savings associations be granted authority for direct equity investment in real estate.

The proposals I have just recounted all look to the future. They are long-range solutions to a problem that exists today, and can not possibly impact immediately on our institutions or the communities we serve. Short-term assistance is needed as well, and I am pleased to observe that the House Banking Committee has reported out H.R. 6267, Chairman Fernand St Germain's "Net Worth Guarantee Act," which would provide capital assistance to thrift institutions, commercial banks and credit unions whose net worth ratios have fallen below 2% of assets in this time of general economic stress. I should point out that this legislation, which has now gone to the Rules Committee, carries no direct Federal Budget outlay and therefore does not affect the deficit which seems to preoccupy those on Wall Street who determine the level of interest rates, generally. I hope the Members of this distinguished Subcommittee will add their support to H.R. 6267 when it is brought to a vote on the House floor, perhaps as early as this afternoon.

Just last week the House passed H.R. 6294, the "Single-Family Housing Production Act of 1982," which would

provide an interest rate buydown of up to six percentage points for first-time homebuyers. This bill was designed to stimulate housing production and is expected to create 140,000 housing-related jobs. You have approved $1 billion for this program for this Fiscal Year. Also last week, the House Banking Committee reported out H.R. 6296, the 1982 Housing Bill, which contains a $3.5 billion authorization for the mortgage interest buydown program for Fiscal Year 1983.

Each of these measures will be of tremendous benefit to small businesses in the housing-related fields -- businesses which are bearing the brunt of the current recession and its attendant high interest rates.

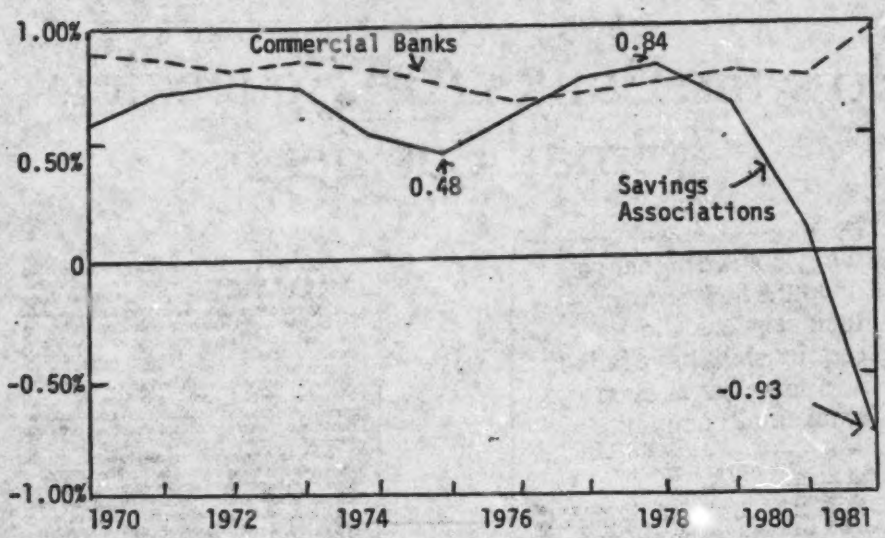
In closing, I would like to touch briefly on three other matters of importance to thrift institutions: (1) First, some means of a "fresh start" which would clear our books of old, long-term, low-yielding loans. Various approaches to this have been discussed here in the Congress and within the thrift industry, including what is known as "statutory recapitalization." This is an accounting concept which would permit a one-time marking to market value of our loan portfolios as a means of maintaining our balance sheets at levels acceptable to the Federal Savings and Loan Insurance Corporation; (2) Second, we must review the All Savers Certificate, the tax incentive for savings which was included in the 1981 Economic Recovery Tax Act. Authority for this savings program is due to expire on December 31, 1982, at which time we can expect an outflow of these deposits -- unless the

authority is extended or a substitute of some form is authorized this year. With any luck, we hope to see signs of a recovery in the housing industry later this year, but a sudden outflow of All Savers deposits could well dampen that recovery; (3) Third, while we hope it never has to be used, we urge extension of the Credit Control Act of 1969, which is due to expire on June 30. This stand-by credit control authority is a vital tool for the management of a successful deregulation program in periods of high interest rate volatility in that it provides added insurance of rate stability. Chairman St Germain's H.R. 6124 addresses this, and we believe his bill merits your support.

The picture I have painted of savings and loan associations in a deregulation climate is not an optimistic one, I grant you. But we remain optimistic, so long as there are Members of Congress who understand and appreciate the destructive nature of mismanaged deregulation. As I said at the outset, we are not opposed to deregulation. We welcome it. But it must be balanced. We have suffered and our communities have suffered as a result of unbalanced deregulation. This Congress has an opportunity to correct that imbalance and to ensure that the thrift industry is armed with sufficient new lending powers to reestablish it as this nation's most reliable source of housing finance, as well as a reliable new source of capital for the small businessman and woman.

EXHIBIT 1

RETURN ON ASSETS OF COMMERCIAL BANKS AND SAVINGS ASSOCIATIONS



SOURCE: FHLBB, FEDERAL RESERVE BOARD.

	Insured Commercial Banks	Insured Savings Associations
1970	0.90%	0.57%
1971	0.86	0.72
1972	0.83	0.79
1973	0.85	0.77
1974	0.81	0.55
1975	0.77	0.48
1976	0.70	0.64
1977	0.71	0.79
1978	0.76	0.84
1979	0.81	0.68
1980	0.80	0.13
1981	0.98e	-0.93

SOURCE: FHLBB, FEDERAL RESERVE BOARD.

Sunday, April 25, 1982

Exhibit 2

The New York Times
Business

How the Banks Are Squeezing Small Business

They charge higher rates on loans and more for their services. Old relationships have faded, and some banks even shun small companies.

By ROBERT A. BENNETT

MANY of the country's small businesses are recounting experiences similar to that of Utility Industries of Somerdale, N.J.

"If we borrow, it's two or three percentage points above the prime rate, while big companies borrow well below the prime," said Wiley J. Pickett, owner of the $500,000-a-year company, which makes devices to pull cables through conduits. "Not that I'm complaining about what big business gets. It's what small business doesn't get," Mr. Pickett added.

Then there's the kind of experience of another small company, Accurate Inventory Services in New York. Accurate, which does inventory accounting for client retailers, had been doing business with the Chase Manhattan Bank for almost 20 years. But then Chase told the company to take its business elsewhere.

"They said they couldn't make enough money on a $25,000 loan," said Arnold S. Gerber, the Accurate inventory's president. "They made no bones about it, they literally told me to go to another bank," Mr. Gerber said.

The Government says that of the 11 million businesses in the United States, 10.8 million are categorized as small, with fewer than 500 employees. They are called the backbone of the American economy, with good reason.

According to the Small Business Administration, these companies have generated more than half of the new product and service innovations developed since World War II. In addition, they employ about 39 million people, or half the nation's work force. Most of them rely on the nation's banks to provide them with the means to grow and the funds to ease them through the shoals of the economy's cycles.

Of late, many of these companies have found these relationships becoming increasingly uncomfortable. The banks have been charging small business higher interest rates than big business. They have been raising the fees they charge for their services far beyond the general rise of prices. And some banks have been turning their backs on their small-business customers of many years.

What's more, many small banks, themselves small businesses, are being gobbled up by bigger banks. As a result, the banks have been shedding the personal relationships that gave a small bank confidence in its borrowers.

The banks, for their part, say they have little choice. They note that many small banks have been forced to merge into larger banks because their costs were running far ahead of their small-town fees. At the same time, the small banks' own cost of money — what they pay on their deposits — has been soaring to keep deposits from fleeing town to high-yield money market funds and the like. No longer, therefore, can a small bank and a small business remain insulated from economic trends beyond their local community.

FOR their part, the banks say that dealing with small business is more time consuming, more costly and riskier than dealing with a General Electric or I.B.M. Banks contend they must either charge enough to cover their costs to make a profit, or shun business with small companies entirely, and different banks have taken different courses. The Bankers Trust Company, for example, has nearly stopped dealing with very small enterprises — mom and pop stores and the like. Others, by contrast, have geared up for this kind of business and are eagerly courting it.

"It's a very profitable marketplace for us," said Robert L. Lipp, senior executive vice president of the Chemical Bank, which has been particularly aggressive in seeking the business of small companies.

Courted or not, the credit situation at many small companies appears to be nearing a critical point — and for some bankrupt businesses, that point already has been reached. The fear, according to Milton D. Stewart, editor of Inc., a magazine for small business and head of the Small Business Administration under President Carter, is that the number of small-company bankruptcies will continue to soar as a result of the recession and high interest rates. New businesses

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How the Banks Are Squeezing Small Business

Continued from Page 1

have been forming at a healthy rate in recent years—but they have been collapsing at record rates as well.

According to the Small Business Administration, only about one out of every three new companies with fewer than 20 workers survive more than four years, and fewer than one out of 10 survive a decade.

"Small business needs credit in place of equity," Mr. Stewart said. "How far can you stretch the rubber band?"

High interest rates are a major problem, but a greater problem is the more availability of credit, Mr. Stewart continued. And this problem is getting worse as small banks, which account for two-thirds of all credit to small business, are being swallowed by bigger banks.

To the average small-business man, the situation is confusing as well as difficult. He sees one bank raising rates and wooing him, and another pushing him out the door.

Jackie Kleiner, for example, an attorney in Atlanta who is suing several banks on behalf of small businesses, claims that by raising their fees "banks are showing they don't want these customers." But Mr. Kleiner also accuses the banks of charging small concerns so much that "the small-business community is subsidizing the big-business community."

Interviews with small companies around the United States turned up numerous complaints, but banks, citing the confidentiality of their relationships, usually would not discuss their relations with specific customers.

MANY of the businessmen interviewed said that money isn't everything, even when it comes to banking. Often, a businessman's relationship with his bank takes on a personal tone, making the small-business man reluctant to switch accounts.

Paul Heerema, chairman of the Heerema Company, a food-equipment distribution and refrigeration business in Haledon, N.J., recalled how his relationship changed after his local bank was taken over by a bigger bank—which he won't name, he said, because "I owe them money."

"It's not like it used to be," Mr. Heerema said. "We've just become a number," he said. "It's very impersonal. The people who make the decisions are 20 miles away."

The Heerema Company has sales of between $4 million and $5 million a year, and usually has about $50,000 in credit outstanding, paying a rate of one to one and a half percentage points above prime. "It has been worse in the past," he said.

In dealing with big banks, small-business men complain of a lack of understanding. William H. Kelly, president of Bank and Office Interiors Inc. of Seattle, contends that the failure of the Seattle-First National Bank to comprehend his business was the reason his company switched its business to the First Interstate Bank of Washington.

Citing a study by the Stanford Research Institute, Mr. Kelly contended that his industry was rapidly expanding and changing. "We no longer can be a mom-and-pop type operation," he said. His company now has annual sales of about $20 million, and has been growing at a yearly rate of 15 to 20 percent, Mr. Kelly said.

At the same time, Mr. Kelly added, the basic character of his business is changing. The price of the employee work stations that he sells has soared to about $2,500 per unit, from only $900 to $700 five years ago. "That means we need more credit," he said.

SEATTLE-FIRST NATIONAL was unwilling to finance "what was mainly our in-process inventory," Mr. Kelly continued. Then, he moved the company's account. Now, Mr. Kelly added, his credit needs are met—at one and a half percentage points above prime.

Mr. Pickett of Utility Industries, like many other small-business men, contends that "banks will only lend when you don't need it."

One of Mr. Pickett's biggest complaints is the difficulty he has in getting short-term loans so that he can get large discounts on materials by paying early. Too often, he said, his bank will not go along.

Mr. Pickett said he might consider going to an accounts-receivable or factoring company, which would lend against the security of either the goods produced or the purchasers' promises to pay. But he said such companies charge interest rates and fees that are so high they wipe out any potential benefits. Even with their high rates, banks still offer the lowest rates available to small business.

Meanwhile, bankers contend that it often takes a lot more time and effort to determine the creditworthiness of a small business than of a major corporation, and that often a lot more paperwork is involved, especially if the loan is guaranteed by the Small Business Administration.

In addition, the income earned on a small-business loan, even at a high rate, is tiny compared with that earned on a big loan. For example, if the prime rate is 16½ percent, and a bank makes a $50 million loan to a major company at two percentage points below the prime, the bank's annual gross annual income from that loan would be $7.25 million. But the gross income from a $100,000 loan at three percentage points above the prime would be only $19,500. Assuming that the cost of funds to the banks was 2½ percentage points below the prime, the net pretax yield to the bank on the big loan would have been $250,000, and on the small loan, $6,500. Yet, it might have taken more time and substantially more risk to make the $100,000 loan than it did to make the $50 million loan.

At the same time, banks are finding that the cost of services as well as loans have been rising, and, contend they have not been charging enough for outstanding services. Thus, there have been sharp increases in many fees.

Citibank is typical. Over the last three years, it has doubled many of the fees it charges the smallest of its business borrowers. If a company deposits a check in its Citibank account and the check bounces, Citibank charges the company $3, up from $1.50 three years ago. Similarly, it has doubled the charge for a stop-payment order, to $6 from $3; it has doubled the fee for each night deposit, to $1 from 50 cents; it has increased the penalty for overdrawn accounts to $7 from $5, and it has raised the price for each roll of wrapped coins to 10 cents, from 6 cents—a high price for retailers, for example, that do a heavy cash business.

" But a company may not have to pay any such fees if it can maintain a high enough balance in its checking account. At Citibank, as long as a business keeps at least $1,000 on deposit, it gets a 15-cent credit for each $100, up from 10 cents in 1979. Thus, if the company's balance is large enough, it would not have to pay any direct fees for the services it uses.

The deposits are useful to banks because they are interest-free, and banks can make substantial profits by reinvesting them.

Without such balances, small companies, the banks contend, are expensive to service and the cost of servicing them has to be met either with interest-free balances or direct fees.

It appears that a major problem in the relationships between small-business men and their bankers is that these entrepreneurs do not fit easily into the corporate molds established by the banks. Banks like to set up neat categories so that they can mass produce financial services.

The banks expect them to maintain records similar to those of major corporations — a practice that most small-business men say they cannot do. What they want are personal relationships in which the banker understands the basics of the business.

SOME banks is trying to build their small-business division, seem to be doing just the opposite of what the small-business men say they need.

Carl Gustavson, senior vice president in charge of Chase Manhattan's community bank division, said that last year the bank set up a special unit to deal with loan applications from small businesses. The applications are gathered at branches and sent to the special unit for approval.

"We recognize that small companies don't have the same kind of financial statements that big corporations do and that's why we set up the special unit, to concentrate our expertise," Mr. Gustavson said. But by moving the loan-application approval process beyond the branches, it also separates the function from the businessman. Those banks that have efficiently geared up their small-business activities are enthusiastic about the field because, done properly, it can be more lucrative than lending to bigger companies with more bargaining power.

More than most banks, Chemical seems to have adjusted to the needs of small businesses.

"It all depends on personal relationships at the branch level," said Mr. Lipp. "It's a very personal sell."

Unlike most other large banks, Chemical's branch managers have the authority to make loans of up to $100,000 and they are paid bonuses for generating such business.

According to Mr. Lipp, the policy has more than doubled its small-business checking account deposits over the last five years, to $1.3 billion, from $600 million. If Chemical invested that extra $700 million of interest-free deposits at prime, now 20¼ percent, it would increase the bank's pretax earnings by more than $113 million — significant even for a $30 billion institution.

BUILDING **BANKING RELATIONSHIPS**

Alan I. Rubin, right, owner of RCI Discount Appliances, which operates two stores on the Upper West Side of Manhattan, says he needs to build a close relationship with the banker who must decide on his loans. He says he needs someone who can understand his business. "I've been fighting with Citibank for years, and finally I'm getting somewhere," Mr. Rubin said. "I'm building a track record."

Mr. Rubin is one of thousands upon thousands of small-business men who feel squeezed, but not necessarily ignored, by banks they've used for years.

A major problem facing Mr. Rubin is whether he can believe bankers who say they want his business. For example, Mr. Rubin said Chemical Bank had been been courting his business aggressively for three years and, "from what they say, they seem to be more tuned in to the needs of the smaller business than Citibank."

But in actual practice, there remains some doubt. For each of the last three years, Mr. Rubin said he has had the opportunity to buy a number of air conditioners at an unusually low price — all he needed was the money. To Mr. Rubin, sales of the air conditioners "were virtually guaranteed" because of the hot weather and the price at which he could resell them.

Citibank saw it differently, however, and declined to lend RCI the money without collateral.

"In my discussions with Chemical, they said, 'We would help you in that kind of a situation,' " Mr. Rubin said. But, he continued, Chemical said it would make the loan only if it got all RCI's business, including its checking account, charge-card servicing and, most important, a loan that RCI had from Citibank that was guaranteed by the Small Business Administration.

Chemical said, however, that it could not go to the S.B.A. merely to take a loan away from another bank, but that RCI would have to increase the loan. Until last year, Mr. Rubin was reluctant to do so, he said, because he would have had to have paid a 1 percent fee on the entire loan amount.

Last year, however, he agreed to switch to Chemical so long as the loan was approved. But Chemical never approved it, he said. And the reason at that time was not clear.

Earlier this year, Mr. Rubin returned to Chemical and discussed a non-S.B.A. loan, on which he would not have had to pay the 1 percent fee. RCI would have used the Chemical loan to repay the Citibank loan. "I was turned down again on the basis that Chemical doesn't take a loan away from another bank," Mr. Rubin said. Thus, Mr. Rubin is still struggling with Citibank. "I've had four loan officers in the last one and a half years and every time somebody else came in, I had to start all over," Mr. Rubin said.

But Mr. Rubin remains confident. "By next year," he said, "Citibank will understand me."

Mr. NOWAK. You do have some optimistic notes in your statement. If I were president of a savings and loan, I don't think I could get that optimistic myself after looking at some of the so-called red ink that has been developed.

When we are talking about the structure being changed, I don't think anybody could disagree with the statement that the banks especially have been caught unaware of this tremendous change that has occurred. And you really didn't have the opportunity or the tools, as you have said in your statement, to compete.

I want to get back to that a little later. But you know when we look at this whole structural change, this free market system, total deregulation coming into the structure immediately, is there a concern, as has been expressed by other witnesses especially in the thrifts, that you are not going to be able to withstand that kind of competition? I think you could because of the personal relationships, if everything else was equal in the community.

But how are you going to be able to compete—not on the lending side because that is easy to see—how are you going to compete for the deposits if you have an institution that is many, many times as large as you are coming into a community? And even if the differential is half of 1 percent, how are you going to compete for the deposits with that kind of structure?

Mr. GLOVER. OK. I think it is going to be more difficult to compete as these changes come. However, in many of the smaller communities in some of the rural counties and some of the rural States, the small associations have done much better than the large savings and loan associations have. We have a better net worth, in many cases. And we have been very fortunate in our community that we have been able to compete with three large commercial banks in the area right now. We have a commercial bank, which is the largest in the State of Ohio, which is Ameritrust. We have Society Bank of Cleveland, which is third or fourth in the State, and BancOne from Columbus.

We are effectively competing with them right now because of our local flavor, and the fact that we are interested in the people, and they still have confidence in us.

It is not going to be easy. But I do believe that if we have more flexibility in our lending powers where we will be able to make loans that will have adjustable rates as we are now allowed to do on mortgage loans, and maybe with some extended powers, we can get into the small business area where we have been highly restricted because of our asset limitations. I believe that we are going to find that we are going to be able to compete equally as well as a small commercial bank is able to compete in that type of atmosphere.

Mr. NOWAK. Now we are going to have a constriction, I think, of all economic activity. And certainly that goes for the banking industry as well.

Mr. GLOVER. Right.

Mr. NOWAK. That constriction is projected for the next 2 or 3 years. I think one of the big mistakes this administration has made, is claiming things are 3 months away from booming in this country because of a small adjustment of the Tax Code. I don't believe that can be true of the system at the speed that they keep

referring to. It is going to take a much longer adjustment time especially with the new structure. This change is something that has just revolutionized the financial market, and the whole economic game plan that has been out there since the 1800's.

With the situation you are in now, and unless something is done to make you even, so that you can start on the same competitive level, I am wondering how you are going to compete with current mortgages? It used to be that in 7 years you could change over all your mortgages. Right?

Mr. GLOVER. Right.

Mr. NOWAK. Throw out the old and bring in the old. That is going to be stretched out to date *X*. So I don't think you can depend upon even that 7 years anymore. We have eliminated so many people from initial participation into the housing industry. And for many, that's the only participation they have in the free market system or any chance of equity growth.

We change this all around and say now we have got variable mortgages. And your interest rate goes from 8½ to 14 or 15 or 16 in most areas now. How long is that going to take before you can compete?

Mr. GLOVER. I think what we are going to see happen, and what is happening already, is that there are going to be many savings and loans as well as many commercial banks who are going to be forced into mergers with this type of situation. And there are going to be a lot fewer financial institutions in the future. I don't necessarily like that prospect, but I believe that that is something that is going to happen. There are going to be many who will not be able to compete under these types of conditions. There will be many of us who will either be forced into a merger situation or attempt to operate and hopefully will be able to if we have the new powers. I think the thrift industry needs a period of time to adjust to the fact that we do have those long-term, fixed-rate mortgages on our books.

Mr. NOWAK. But how are you ever going to overcome that from the base you are starting with? The point that you are carrying those mortgages out at those rates? Even if you get a new influx of money, you are going to be in a competitive situation trying to keep your margin. And if you have a new institution come in and start drawing off and starting at a base of loans that are variable or at least 15, 16, 17 percent, how are you going to catch up with that?

Mr. GLOVER. Well, some of the associations have sold off mortgages at a discount and reinvested in other mortgages or in the secondary market. They have taken a loss and spread it out over a period of years. Many associations are doing that at the present time.

Mr. NOWAK. I have seen that occurring. A couple of Virginia banks have recently sold off almost all their assets to get some cash. How widespread is that?

Mr. GLOVER. I think it is occurring at a fairly rapid rate. I don't have any idea how many companies have done that. But I have talked to several that have done that, and who have sold off a large portion of their loan portfolios, maybe taking the loans that were 10 percent or below and spreading the loss over the remaining

term of the loan, 15, 18, 20 years or whatever it would happen to be. They have been able to find satisfactory investments in the secondary market, and they have been able to make it work. Of course, there are cases where it won't work, depending on what you can reinvest it at. A lot of it depends on what the market is at the time that you attempt to do it.

Mr. NOWAK. Yes; what is your rate for a mortgage?

Mr. GLOVER. Right now it is 15 percent on an adjustable rate mortgage.

Mr. NOWAK. Three years?

Mr. GLOVER. No; this is a 1-year adjustment now.

Mr. NOWAK. One year adjustment. How many mortgages have you written at that rate over the last year?

Mr. GLOVER. We have had hardly any activity in the last 3 or 4 months. We started off with the adjustable rate mortgages about 2 months ago. It was just a matter of six or seven loans. We've had no applications and no activity.

Mr. NOWAK. The commercial having any activity?

Mr. GLOVER. No; no mortgage activity. As a matter of fact, our rate is lower than anyone else in our area and we are still not attracting anyone. Ashtabula County's unemployment is close to 17 percent right now so there has been very little activity as far as real estate sales go.

Mr. NOWAK. Another aspect of this that really isn't clear as far as its impact is the so-called creative financing that is going on. I talked to a realtor about this and they are coming up with figures as high as 65 percent of all resales not happening with any institution at all. It's an expansion of credit within the buyer-seller.

Mr. GLOVER. Well, there has been quite a bit of creative financing. I think if I am not mistaken, I saw not too long ago in the Wall Street Journal or one of the news reports that a lot of this creative financing is starting to backfire now. Many of the people have found out that due on sale clauses are being enforced in some of the transactions. And they just aren't working out the way that they had expected. The realtors, quite frankly, have not been working with the financial institutions. And I am sure that there are things that could be done to improve this situation by a blending of rates, allowing assumptions, and adjusting rates and so on that many lenders are doing now. Quite frankly, most of the mortgage activity we have had has involved an assumption of an existing mortgage at a below market rate, with any additional funds that were advanced at market rate. They come up with a blended rate, and that has created some activity.

In our smaller community, we don't have all of this creative financing going on to the extent that it is some places. And one thing is that we normally are aware of the transactions that go on. And the realtors in our area have been fairly cooperative with us.

Mr. NOWAK. I know some of the large institutions have hired people just to sit at the county clerk's office and read deeds all day to try to pick up some of these assumptions.

But over and above that, especially if the person has built a sizable equity in the house, they are taking back very large second mortgages on the properties. And they are trying to give a blended rate so that somebody can buy the property and keep up the pay-

ments. That is going to restrict the sales for umpteen years. The institutions won't have the requests with this new structure.

Mr. GLOVER. Mortgage rates have got to come down. Interest rates have got to come down. This gets back to what everybody is talking about. And, of course, we can say the Federal deficit has got to be reduced, which certainly would be helpful. And I think we have to accept the fact that maybe we have been living in an affluent lifestyle and that maybe we are not going to be able to have some of the things that we have had in the past. Maybe we are going to have to back off and hurt a little bit before things get better.

Mr. NOWAK. A little bit?

Mr. GLOVER. It depends.

Mr. NOWAK. Seventeen percent unemployment. [Laughter.]

Mr. GLOVER. They are hurting a lot.

Mr. NOWAK. It hurts a lot. And I just feel the whole psychology of this thing is going to be in the market place. We will be rippling through this economy for years to come.

I can't understand how changing all the structure and saying, let's let the money flow out. As I said before, this passive income argument on only a couple hundred thousand dollars—you can live very nicely if you get that 17 percent on a couple hundred thousand dollars without ever risking it or worrying about it. And even doubling it in whatever time it takes—4 years and some months under the present system.

Mr. GLOVER. I would like to confess that I knew what the answer was. And I know that there are many, many people much more intelligent than I am who can't possibly figure out what is going to happen or predict what is going to happen. The only thing I can state is the frustration that I face as a manager of a savings and loan, a small savings and loan, in doing everything we can to attempt to stay in business, and offer the people in our community what they need and what they deserve. I don't have the answer. I wish I did. But I believe we are going to make it.

Mr. NOWAK. When the structure changed and the money market became an instrument and the CMA came into effect without any other adjustments, we, as a nation, encouraged through the Tax Code or through other overt funding programs for the housing industry. And we have told the banks and savings and loans and thrifts that this is what you are in existence for. You are going to help America grow. We are going to give you the opportunity to lend money at reasonable rates, and you make your differential. We are going to regulate you so that you can't do anything else. We are going to tell you to do it and mandate you do it. And then in 1 year that has all changed.

Mr. GLOVER. And we carried out the mandate of Congress.

Mr. NOWAK. And you carried out the mandate of Congress and the administration for years and years. When this thing was changed, it was just like somebody took another small step down a little different road. It really has such impacts out there, we are seeing the effects on small business, but it really runs through the whole lifestyle of the American family.

There was much talk last year that we can balance the budget. All we would have to do is take one line out of the Tax Code that

calls for the interest deduction on the mortgage. And we can just eliminate that and pick up $39.7 billion. If we really want to balance the budget, why don't we do that?

Mr. GLOVER. Of course, that would be ideal. That is not going to happen overnight. That's the problem. It is going to take time to get to that place. If we had been in a position in 1978 where we could have been competitive when the things changed so rapidly and—if we had had help on the asset side—we wouldn't be in the position we are in today.

Mr. NOWAK. But the lack of demand out there is really probably two things. The kind of rates that are available and reductions in the personal income.

Mr. GLOVER. That's right.

Mr. NOWAK. They are hitting the whole Nation, and, unfortunately, affecting yours at a horrendous rate. We changed the rules so drastically, I'm just afraid especially for the thrifts. They are not going to be able to adjust unless we put you on an even keel to start off again. Then you are going to be competing with giants.

Mr. GLOVER. That's right.

Mr. NOWAK. I have some real doubts. If there is a differential they can get somewhere else, they are going to take it. If it is a matter of a half a percent or three-quarters of a percent deposit, I think they are going to do it.

On the lending side they will come to you and sit with you all day and have coffee and explain their problems but they won't reach the other guy that they have left their money with. Do you think that is happening? Anybody withdraw money from your bank and put it in a money market certificate or the Merrill Lynch?

Mr. GLOVER. I'm sure that we have had some of that. And, of course, that has been the case industrywide. We have been fortunate at our particular institution to do fairly well, but well below what we would expect that we would normally do. But that's not true of most associations.

Mr. NOWAK. Have you held your asset level or your deposit level?

Mr. GLOVER. We've held ours with a minor increase this year. But the number of associations who have had that increase is very, very minimal. As you are aware the losses in the savings and loan industry in deposits are extremely high.

Mr. NOWAK. I guess you sit in a little better position than some of the thrifts in the cities, too. You must have had a substantial shift from your so-called regular passbook accounts into the——

Mr. GLOVER. Some have gone into the money market fund in the 2½-year certificates of deposits. And our costs of money have increased, of course, drastically since 1978.

Mr. NOWAK. Well, there is an indication of what we have gone through in the past and what we are going to face. And you know each bank out there is going to have to make an awful lot of adjustments. I think people are going to make a lot of adjustments. They will say, maybe our standard of living went up too fast, went up too high, and we have got to pull back. We have got to restrict certain things. We have got to constrict opportunities out there for

homes for people to live in. But when you do that, I think it is going to take an awful lot before you come near breaking it down.

But I also agree with many of the suggestions you have made here in relation to the changes that have to be made at least to give you that opportunity in the future. Even with that opportunity, you are going to have a difficult time. But that remains to be seen.

Mr. Fary, do you have any questions?

Mr. FARY. I have no questions, Mr. Chairman.

Mr. NOWAK. All right. I want to again thank you for coming, Mr. Glover, to express your statements. And I think we will try to get this distributed to many, as I stated before.

We will have another hearing tomorrow. And some of the other associations will have, I think, some similar statements to make. But let's try and bring together as much broad thought as we can on this subject not only for the members here to digest but for the other committees such as Banking and Currency. We will be sure to give this information to them directly in case everybody doesn't have an opportunity to get in over there, which is sometimes the case.

But your testimony, I think, shows very well that there is a tremendous imbalance existing out there today. And it is going to take some time to really adjust.

Mr. Fary, go ahead. Do you have a question?

Mr. FARY. Thank you, Mr. Chairman. I happened to notice one that I scribbled out earlier. Maybe I can read it.

Mr. Glover, does interest not go down as total deregulation forces open competition? Do you feel that thrifts would need a substantial reduction in the requirement that a large percent of their portfolio be devoted to housing financing?

Mr. GLOVER. I would think that that's probably very true. We would have to be in a position where we would be able to make more commercial loans. And in this case when we are talking about small business loans, those people in our community who would come to us that we can't help now, we might be able to help and be able to put our funds into that type of loan even if we can't make housing loans.

Mr. FARY. On the Public Works Committee and the Subcommittee on Aviation—we were the first to deregulate. And to this minute, I can't find out whether it was good or whether it was bad. Some say "yes" and some say "no."

Mr. GLOVER. It depends on whether you are Braniff or not. [Laughter.]

Mr. FARY. We went in for the trucking and now we are worse off.

Mr. GLOVER. As far as the thrift industry goes, if the deregulation had been a little more gradual, we might have had a little better opportunity to defend ourselves.

Mr. NOWAK. Well, we might give you a call on some other inquiries when we get down to assemble all of this. We want to again thank you for taking the time on behalf of your bank and your association to express these thoughts. We are certainly going to look forward to at least making you whole.

Mr. GLOVER. We appreciate that.

Mr. NOWAK. That is probably the least we can do. And then you are going to have to sustain yourself.

Mr. GLOVER. If you make us whole, we will be ready to plan, I guarantee you.

Mr. NOWAK. Thank you very much.

Mr. GLOVER. Thank you, Mr. Chairman, and the committee.

Mr. NOWAK. We will recess these hearings until tomorrow at 9:30. Thank you.

[Whereupon, at 12:55 p.m., the subcommittee adjourned, to reconvene at 9:30 a.m., Thursday, May 20, 1982.]

BANK DEREGULATION AND ITS IMPACT ON SMALL BUSINESS LENDING

THURSDAY, MAY 20, 1982

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES, COMMITTEE ON SMALL BUSINESS,

Washington, D.C.

The subcommittee met, pursuant to notice, at 9:45 a.m., room 2359-A, Rayburn House Office Building, Washington, D.C., Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. NOWAK. Good morning. This morning we would like to continue our hearings on bank deregulation and its impact on small business lending. Yesterday, we heard from the Office of Advocacy of the Small Business Administration and representatives of the banking industry. Today's witnesses consist of small business groups who will present their views of the small business community. In addition, we will hear from Chemical Bank of New York, one of our Nation's largest and leading institutions.

We welcome you this morning and look forward to receiving testimony on what, I think, is becoming a vitally important subject as we move through all of the work in Congress.

Our first witness this morning is from the National Association of Wholesalers & Distributors. Robert E. Laughlin, I would like you to come forward.

Mr. Laughlin is the chief executive officer of Western Food Equipment Co. of Portland, Oreg. We welcome you before the committee and I might just state at the outset that we will print your entire statement in the record and you may proceed as you desire.

TESTIMONY OF ROBERT E. LAUGHLIN, CHIEF EXECUTIVE OFFICER, WESTERN FOOD EQUIPMENT CO.

Mr. LAUGHLIN. Thank you. Mr. Chairman, members of the committee, and guests.

I thank you for the privilege of testifying on behalf of the Western Food Equipment Co. and many other small businesses for whom we would speak related to our election by our peers as an Oregon delegate to the January 1980 White House Conference on Small Business. While a member of the National Association of Wholesaler-Distributors, my views are my own, and do not reflect those of NAWD.

You will find enclosed "Who Am I, Who Do I Represent and Why Am I in Washington Again?" It provides details of my association at Western, a Portland-based, regional warehouse and wholesale distributor, where I have been associated for 34 years and have had the final administrative responsibility for the past 12.

I am opposed to any changes that would put greater pressure on small business and continue the present high interest rates and allow the present "phony, prostituted, posted prime fib." Our enclosures will refer to the House Committee on Banking staff report released April 30, 1981, and we applaud Congressman St Germain and would support his position in the cover letter and would encourage suggestions including that the industry abandon its painfully drawn qualifications about the prime rate and adopt in its place a lowest interest rate for business borrowers with all other rates scaled upward from that rate.

We ask that you review carefully his 3-page letter. I am just summarizing some of my high points of the written report on page 2. Unfortunately, there has been no effort by the larger banks to move away from the misleading term "prime," which, especially during the past 2 years, could be more accurately defined as a base point or average from which it appears that discounts as high as 6 points have been given to larger businesses while charges of over 6 points have been made to the smaller businesses.

Our enclosures will include the AP reprint of last December from John Cunniff, "Many Angry Customers Wage Prime Battle against Banks" and a similar reprint from the Sydney, Australia, Morning Herald, with the headline "U.S. Bank Loses Court Action over Charging High Interest Rates." Also enclosed are copies of "Updating of Progress in Protesting the Phony Prostituted Posted Prime Fib," referring to some of the approximately 20 lawsuits already filed by small business persons against the banking industry and you will see the reference to major settlements already completed, including the United Kentucky Bank and First Pennsylvania Bank.

I would hope in our testimony to again draw attention to the terrible reality that the prime rate is not the best business borrowing rate for the Nation's most creditworthy corporate borrowers. A narrative enclosed with our written testimony, "The Prime is Not the Best," is part of the educational process that we have been attempting to encourage related to our involvement with the White House Conference and the ongoing concerns for high interest rates that have been such a burden for the independent business community.

I believe you will find that a majority of the American citizens consider prime to mean the best piece of meat or the highest viewing time on television and they look forward to the time when we have truth presented by the banking industry to our citizens, rather than misrepresentations.

We would refer you to the semantics change toward accuracy when our trade association, NAWD, successfully encouraged a movement away from the term "wholesale price index" to a more accurate term "producer price index." A similar change is long overdue by the banking industry.

I am here to testify against any legislation or encouragement that would create or allow fewer and larger banks, which I submit would widen the communication gap between the small business and the big bank decisionmakers.

We would refer you to the enclosure from the Sunday Oregonian of January 1980, where John Cunniff reflects the opinion of Arthur Levitt, chairman of the American Stock Exchange, including, "Is fighting for its life too extreme a description of the predicaments of small business?" Small business people don't think so. They say they are being crushed by big business, big government, and big unions. They argue that they are excluded from capital markets, simply because they are too small.

We commend Robert Bennett of the New York Times writing April 25, 1982, "All the Banks are Squeezing Small Business," which is a very detailed reminder that Arthur Levitt's statements are accurate. We also refer you to the written testimony covering some of the facts regarding small business receiving less respect and consideration from big banks than what would appear to be fair.

I am opposed to completion of any current legislation or new bank deregulation legislation that would allow a drastic move toward fewer and larger banks. We would present the three following premises:

(a) Normally the bigger the bank the greater the distance between the small business person and his final loan decisionmaker and the less likely the loan even being approved, no matter what interest rate would apply.

(b) The bigger the bank, the greater the differential between the discount from the prime for big business and the points added as a penalty above prime for most smaller businesses.

(c) The bigger the bank, the fewer small business persons that serve on the bank board of directors setting policies that would show a true concern for the smaller business person.

We are here to testify from personal experience that the United States National Bank, the biggest bank in Oregon, attempted to liquidate this small business, Western Food Equipment Co., in October 1977. "Attempted murder" is my terminology for the unfortunate hit they put out to liquidate Western. While Robert Bennett refers to the continuing general problem, Western is a classic example of fighting for its life. We refer you to the enclosures from John Cunniff of the AP, Sydney Morning Herald and the Wholesaler. These articles also refer to one of the answers to the problem, small business persons forming their own commercial banks.

Please refer to the Oregonian article of just this past Monday, "Stewardship Bank Puts Its Money Where Its Heart Is." Refer also to the Kansas City Star article, "Small Business Bank Fights Prime War."

Who is going to protect 50 percent of our American jobs and small business? We would like to consider that Congress is increasing their respect for small business concerns and we see many good signs. Keep it up. We deserve and expect your support.

Are big banks going to protect small business? I don't trust most of them after the United States National Bank attempt to wipe us out. While we appreciate every consideration that Congress will

give to surviving American small businesses, we at the same time suggest that the small business community had better not count on big business and big government, but, instead, they should be doing whatever possible to help themselves where they are in forming their own commercial banks, maybe one of those alternatives.

It is significant that I have met with more than 30 groups from Anchorage, Honolulu, Los Angeles, Miami, Boston, Seattle, and points in between, and, in view of the threat of interstate banking, we are encouraging a revolution in American banking that may see 100 small business owned banks operating within the next 5 years. The small business community has always had a reputation of helping themselves and this would be one of the alternatives to be considered.

Western's unique experience with the United States National Bank is bad news. Small business owned banks are good news and we encourage the small business persons to help themselves and hang together or hang separately.

Another area of bad news is when we took our complaint, which might be shortened to "attempted murder" of 1 company and 30 jobs to our Federal regulatory agency, National Bank Administrator/Comptroller of the Currency in January 1980. Immediately following involvement with the White House Conference on Small Business we provided documentation of our grievance and now show, almost 5 years later, that Western has continued to grow, and create new jobs, and that our complaint has until now fallen on deaf ears.

We as yet have found no satisfaction from the consumer complaint specialist. One of my reasons for being in Washington today is to continue this complaint and we have asked for the support of our Congressmen, the SBA Chief Counsel for Advocacy, and others that we might have a respectful hearing, instead of a whitewash. Copies of the 7-page summary of our concern is included in our written testimony.

My experience so far is that the National Bank Administrator does not publicly reprimand United States National Bank or any other big national bank, but rather, instead, that these sacred cows, called big banks, can literally get away with attempted murder of small business with no support from the regulatory agency.

Unfortunately, it is my impression, instead, that the big banks tell the Comptroller of the Currency when to jump and how high. Check out whether Western deserved to die in 1977 and whether the national bank examiners have done anything to publicly or privately reprimand United States National Bank.

Yes; we have had some firsthand experience with the communication gap between a small business and a senior loan committee of a big bank, none of whom had ever met the Western management or visited the premises and, yet, who instructed the liquidator of United States National Bank to proceed with voluntary or involuntary bankruptcy of Western.

During the past 5 years I have spent 98 percent of my time helping Western to continue to grow. Gross revenues were up again last year about 24 percent. Western has continued to grow and has also been helping a new, unique small business owned bank with

other innovative profit-sharing principals to become a reality and to share the concept and encourage other small business persons to help themselves in having control of new commercial banks that would provide honest loan policy and fair interest rates as the top priority of the bank operation.

About 2 percent of my time has been taken to ask the "Smoking Gun" at United States National Bank why did you try to kill us? President Bob Mitchell of United States National Bank has, for more than 2 years, refused to meet with me to discuss the implications of the U.S. district court jury verdict of December 1979, which included the confirmation that indeed United States National Bank had made a vicious attempt to liquidate Western. You can see the attachments for our continued request for review of this gruesome experience.

There will be a separate presentation to our Congressman on the theme of malicious litigation used by larger businesses such as Foss American and Foss Electric of Denmark to eliminate American small business. Unfortunately, United States National Bank, instead of meeting with us to review our concerns, has basically said, "Go see your attorney and we will see you in court."

Smaller businesses communicate best with smaller banks who are sincerely concerned for their mutual best interest and we would ask our Congress to recognize the extreme danger to surviving small business persons if there are fewer and larger banks. Western, unfortunately, is the classic example of the bad news that can evolve, whereas Stewardship Bank of Oregon is the beginning example of how the problem might be answered.

Please do not help the big banks to get bigger and thereby threaten the existence of other American small businesses like Western.

I will be more than happy to discuss in more detail the "Watergate in Oregon" story of United States National Bank. We would begin with what do you remember about Watergate and show you how we can match up your horrible memories with what took place in Oregon.

Thanks again for the privilege of sharing our concern with continued strong convictions.

[Mr. Laughlin's prepared statement with attachments follow:]

PREPARED STATEMENT OF ROBERT E. LAUGHLIN, CHIEF EXECUTIVE OFFICER, WESTERN FOOD EQUIPMENT CO.

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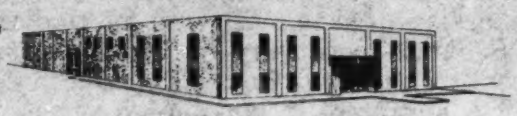
Western
FOOD EQUIPMENT CO.



MANUFACTURERS' AGENTS MA/FSI FOR FOOD SERVICE INDUSTRY

May 19, 1982

Chairman Henry J. Nowak
United States House of Representatives
Committee on Small Business
Subcommitee on Tax, Access to
Equity Capital and Business Opportunities
Rayburn House Office Building
Washington, D. C. 20515

Dear Chairman Nowak:

Thank you for the privilege of testifying on behalf of Western Food Equipment Company and many other small businesses for whom we would speak related to our election by our peers as an Oregon Delegate to the January, 1980 White House Conference on Small Business. You will find enclosed a summary page entitled "Who Am I, Who Do I Represent and Why Am I in Washington Again?". It provides detail of my association as Western Food Equipment, a Portland based regional warehouse and wholesale distributor, where I have been associated for 34 years and have had the final administrative responsibility for the past 12 years.

I am opposed to any changes that would put greater pressure on small business and continue or increase the present high interest rate pattern and allow the present "phony prostituted posted prime fib". Our enclosures will refer to the House Committee on Banking, Finance and Urban Affairs Staff Report released April 30, 1981, and we applaud Congressman St Germain of Rhode Island and would support his position in the cover letter of April 30, 1981, and would encourage suggestions including "that the industry abandon its painfully drawn qualifications about the prime rate and adopt in its place a 'lowest' interest rate for business borrowers with all other rates scaled upward from that rate." We ask that you review carefully his three page letter from which we will quote again. Mr. St Germain urged, "That the commercial banking industry take steps to institute reforms in this area and make certain that understandable rate schedules are made publically available. The bank supervisory agencies should abandon their apathy and take specific steps to assure that the banks adopt a more equitable means of dealing with the question. It is not enough for an agency to simply collect the data with a bureaucratic shrug of the shoulders. Should voluntary and supervisory efforts fail to

create a rational, fair and understandable pricing system that means what it says, the Congress should consider action to protect the public's right to have access to accurate data about this vital sector of the American marketplace."

Unfortunately, there has been little apparent effort by the larger banks to move away from the misleading term "prime" which, especially during the past two years, could be more accurately defined as a base point or average from which it appears that discounts as high as six interest points have been given to larger businesses while, on occasion, charges of over six points have been made to the smaller businesses. Our enclosures will include the Associated Press reprint of last December from John Cunniff "Many Angry Customers Wage Prime Battle Against Banks" and the similar reprint from the Sydney, Australia morning Herald authored by Elizabeth Wynhausen in New York with the headline "U. S. Bank Looses Court Action Over Charging High Interest Rates". Also enclosed are copies of "Updating of Progress in Protesting the 'Phony Prostituted Posted Prime Fib'" referring to some of the approximately 20 lawsuits already filed by small business persons against the banking industry and you will see references to major settlements already completed including the United Kentucky Bank and First Pennsylvania Bank.

I would hope, in our testimony, to again draw attention to the terrible reality that "the prime rate is not the best business borrowing rate for the nation's most credit worthy corporate borrowers". A narrative enclosed with our written testimony "The Prime is Not the Best" is part of the educational process that we have been attempting to encourage related to our involvement with the White House Conference on Small Business and the on-going concerns for high interest rates that have been such a burden for the independent business community. I believe you will find that a majority of the American citizens consider "prime" to mean the best piece of meat or the highest viewing time on television and they look forward to the time when we have truth presented by the banking industry to our citizens rather than misrepresentations.

We would refer you to the semantics change toward accuracy when our trade association, National Association of Wholesale Distributors, successfully encouraged a movement away from the term "wholesale price index" to the more accurate term "producer price index". A similar change is long overdue by the banking industry.

I am here to testify against any legislation or encouragement that would create or allow fewer and larger banks which, I submit, would widen the communication gap between the small business and the big bank decision-makers.

We would refer you to the enclosure from the Sunday Oregonian of January 13, 1980, where John Cunniff reflects opinion of Arthur Levitt, Chairman of the American Stock Exchange including, "Is fighting for it's life too extreme a discription

of the predicaments of small business?" Small business people don't think so. They say they are being questioned by big business, big government and big unions...they argue that they are excluded from many capital markets simply because they are too small. We commend Robert Bennett of the New York Times writing April 25, 1982, "All The Banks Are Squeezing Small Business" which is a very detailed reminder that Arthur Levitt's statements are accurate. We also refer you to the written testimony covering "Some of the facts regarding small business receiving less respect and consideration from big banks than what would appear fair."

I am opposed to completion of any current legislation or new bank deregulation legislation that would allow a drastic move toward fewer and larger banks. We would present the three following premises:

A. Normally the bigger the bank the greater the distance between the small business person and his final loan decision-maker and the less likely the loan even being approved no matter what interest rate would apply.

B. The bigger the bank the greater the differential between the discount from the "prime" for big business and the points added as a premium above "prime" for most smaller businesses.

C. The bigger the bank the fewer small business persons that serve on the bank board of directors setting policies that would show a true concern for the smaller business person.

We are here to testify from personal experience that the United States National Bank, the biggest bank in Oregon attempted to liquidate this small business - Western Food Equipment Company - in October of 1977. "Attempted murder" is my terminology for the unfortunate "hit" they put out to liquidate Western. While Robert Bennett refers to the continuing general problem, Western Food Equipment Company is a classic example of "fighting for it's life". We refer you to the enclosures from John Cunniff of the Associated Press, Elizabeth Wynhausen of the Sydney Morning Herald and the trade association "The Wholesaler". These articles also refer to one of the answers to the problem-small business persons forming their own commercial banks. Please refer to the Portland Oregonion article of just this past Monday of "Stewardship Bank Puts Its Money Where Its Heart Is". Refer also to the Kansas City Star article "Small Business Bank Fights Prime War".

Who is going to protect 50% of our American jobs and small business? We would like to consider that Congress is increasing their respect for small business concerns and we see many good signs. Keep it up! We deserve and expect your support!!

Are big banks going to protect small business? I don't trust some of them after the United States National Bank attempt to wipe us out.

While we appreciate every consideration that Congress will give to reviving American small businesses, we, at the same time, suggest that the small business community had better not count on big business and big government, but instead, they should be doing whatever possible to help themselves where they are and forming their own commercial banks maybe one of those alternatives. It is significant that I have met with more than 30 groups from Anchorage to Honolulu to Los Angeles to Miami to Boston and Seattle and points in between and in view of the threat of interstate banking we are encouraging a "revolution in American banking" that may see 100 small business-owned banks operating within the next five years. The small business community has always had a reputation of helping themselves and this would be one of the alternatives to be considered.

Western's unique experience with the United States National Bank is bad news.

Small business owned banks are good news and we encourage the small business persons to help themselves and hang together or hang separately.

Another area of "bad news" is when we take our complaint, which might be shortened to "attempted murder on one company and 30 jobs", to our federal regulatory agency, National Bank Administrator/Comptroller of the Currency in January of 1980 immediately following involvement with the White House Conference on Small Business and provide documentation of our grievance and now show, almost five years later, that Western has continued to grow and create new jobs and that our complaint has, until now, fallen on deaf ears. We as yet have found no satisfaction from the "consumer complaint specialist". One of my reasons for being in Washington today is to continue this complaint and we have asked for the support of our Congressmen, the Small Business Administration Chief Counsel for Advocacy and others that we might have a respectful hearing instead of a "whitewash". Copies of the seven page summary of our concern is included in our written testimony.

My experience so far is that the National Bank Administrator/Comptroller of the Currency does not publically reprimand U. S. National Bank or any other big national bank, but rather, instead, these "sacred cows" called big banks can literally get away with attempted murder of small business with no support from the regulatory agency.

Unfortunately, it is my impression, instead, that the big banks tell the Comptroller of the Currency when to jump and how high!!

Check out whether Western Food Equipment Company deserved to die in 1977 and whether the Comptroller of the Currency/National Bank Examiners have done anything to publically or privately reprimand U. S. National Bank of Oregon.

Yes, we have had some first hand experience with the communication gap between a small business and a senior loan committee of a big bank, none of whom had ever met the Western management or visited the premises and yet who instructed the liquidator of U. S. National Bank to proceed with voluntary or involuntary bankruptcy of Western.

During the past five years I have spent 98% of my time helping to see Western to continue to grow and help a new unique small business owned bank with other innovative profit-sharing principals become a reality and to share the concept and encourage other small business persons to help themselves in having control of commerical banks that would provide an honest loan policy and fair interest rates as the top priority of the bank operation.

About 2% of my time or less has been taken to ask the "Smoking Gun" at U. S. National Bank-"why did you try to kill us?" President Bob Mitchell of U. S. National Bank has, for more than two years, refused to meet with me to discuss the implecation of the U. S. District Court jury verdict of December 19, 1979 which included the confirmation that indeed the United States National Bank had made a vicious attempt to liquidate Western Food Equipment Company. You can see the attachments for our continued request for review of this gruesome experience.

There will be a separate presentation to our Congressman on the theme of "Malicious Litigation" used by larger businesses such as Foss American and Foss Electric of Denmark to eliminate American small business. Unfortunately, U. S. National Bank, instead of meeting with us to review our concerns, has basically said, "go see your attorney and we will see you in court".

Smaller businesses communicate best with smaller banks who are sincerely concerned for their mutual best interests and we would ask our Congress to recognize the extreme danger to the surviving small business persons if there are fewer and larger banks. Western Food Equipment Company unfortunately is the classic example of the "bad news" that can evolve whereas "Stewardship Bank of Oregon is a beginning example of how the problem might be answered.

Please do not help the big banks to get bigger and thereby threaten the existance of other American small businesses like Western Food Equipment Company!!

I will be more than happy to discuss in more detail the "Watergate in Oregon" story of United States National Bank. We would begin with "what do you remember about Watergate" and show you how we can match up your "horrible memories" with what took place in Oregon.

Thanks again for the privilege of sharing our concern.

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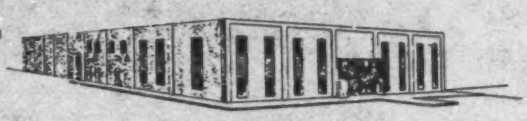

MANUFACTURERS' AGENTS FOR FOOD SERVICE INDUSTRY

May 14, 1982

WHO AM I, WHO DO I REPRESENT AND WHY AM I IN WASHINGTON D.C. AGAIN?

Our organizational chart will describe my function as the Chief Executive Officer of Western Food Equipment Company, a Portland based regional warehousing wholesale distributor where I have been associated for 34 years and have had the final administrative responsibility for the past 12 years. I was elected by my peers as an Oregon delegate to the January 1980 White House Conference on Small Business. I was one of the 11 members of the steering committee for Govenor Atiyeh's conference on Small Business and served as leader in 1981 of the Capital Formation Task Force of the Portland Chamber of Commerce Small Business Council.

I will be back in Washington May 20th as part of a series of 10 visits in the past 36 months concerned for small business needs and continuing with constructive suggestions for improvements. As part of an on-going momentum of small business unity in Oregon, we are grateful for past progress but eager for even more improvements.

We hope to find among our Trade Associations, Federal agencies and Congressional representatives a continued awareness of the WHCSB and continued interest in this very important part of our work force. My interests have been in the area of capital formation which was one of the high priorities of each conference or most discussions with small business persons.

A current issue of top concern is the high interest rate which has been killing too many deserving independent businesses. We would like to have you consider the negative effect of the present "phony prostituted posted prime fib" on small businesses paying well over "prime". There is a packet of material available covering our documentation of this unfortunate current practice and we appreciated the exhortation to the banking community from the House Committee on Banking chairmaned by Congressman St. Germain.

Westerns private placement program has helped us to move ahead and we appreciate the recent changes in security regulations to encourage this capital formation.

We are pleased to have material available covering the progress of the first small business owned bank in the country known as Stewardship Bank of Oregon as mentioned in the May issue of Nation's Business. There are many groups across the country interested in that total concept including some other unique community profit sharing commitments.

Your awareness of our concern for small business problems is appreciated and we will be interested in suggestions you may have for the survival and stabilizing of our small business community.

Most sincerely,

Bob Laughlin
Chief Executive Officer

BL/eir

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223-6317

HOLD FOR RELEASE UNTIL THURSDAY AM's
April 30, 1981

WASHINGTON,D.C., Apr.29 - Chairman Fernand J. St Germain of the Banking, Finance and Urban Affairs Committee said today that the term "prime rate" had become meaningless and urged the banking industry to adopt simpler and more accurate descriptions of its interest rate schedules.

Releasing a staff study on the prime rate, Mr. St Germain said the prime rate "has been so often misused, abused and tortured in recent years that the phrase now seems beyond repair."

The Banking Committee Chairman suggested that the industry abandon its "painfully drawn" qualifications about the prime rate and adopt in its place a "lowest" interest rate for business borrowers with all other rates scaled upward from that rate.

The staff study, based primarily on a survey of the nation's 10 largest banks, found definitions of the prime and its application provided by the banks were "vague and imprecise." The study said that neither "logic nor semantics" prevented the banks from announcing their lowest rate offered the most creditworthy customers.

(more)

"While lending decisions are complex, it is difficult to accept the idea that multi-billion dollar banks, operating with huge staffs and utilizing the most contemporary technology, cannot price their product accurately and clearly," the study said.

The study cited numerous examples of below prime rate lending and said that the misleading nature of prime rate announcements distorted other lending activity.

The study, for example, cited the fact that many small business loans were pegged to the prime rate, moving up or down with each change. The Small Business Administration, the study said, officially ties its lending rates to the prime rate as announced in the Wall Street Journal. Due to the impreciseness of the prime rate as a barometer of actual corporate lending practices, the study urged that SBA and other Government agencies cease the use of the prime in establishing rate schedules.

The study also said that present use of the prime and prevalence of discounts from the rate could lead to price discrimination for smaller firms lacking alternatives in the credit markets. It also questioned whether the prime rate discounting created "imprecise benchmarks" from which to measure the proper enforcement of such laws as the Equal Credit Opportunity Act.

In transmitting the study to the Committee, Mr. St Germain urged that the commercial banking industry "take steps to institute reforms in this area, and make certain that understandable rate schedules are made publicly available."

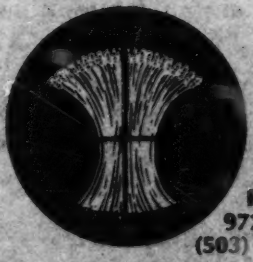
(more)

"The bank supervisory agencies should abandon their apathy and take specific steps to assure that the banks adopt a more equitable means of dealing with the question. It is not enough for an agency to simply collect the data with a bureaucratic shrug of the shoulders. Should voluntary and supervisory efforts fail to create a rational, fair, an understandable pricing system that means what it says, the Congress should consider action to protect the public's right to have access to accurate data about this vital sector of the American marketplace," the Banking Committee Chairman said.

# # # # # # # # # # #

(Staff study attached)

AN INTRODUCTION TO STEWARDSHIP FULL SERVICE INDEPENDENT BANKING



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STEWARDSHIP BANK OF OREGON

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The account that provides numerous financial services for one small monthly fee. The services may include:

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- Personalized Checks
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The account that you can deposit to with any amount at any time and withdraw from the account as you need. Interest is earned from the day of deposit to the day of withdrawal at 5¼% per annum. Interest is compounded daily and credited to all open accounts four times a year, on the last day of March, June, September, and December.

Business Savings:
The account for businesses wishing to maximize their earnings on excess cash deposits up to $150,000. Interest is compounded quarterly at the same rate paid on regular savings accounts.

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The account that can be purchased for as little as $500. The interest you receive is tied to the monthly rate for 2½ year U.S. Treasury Securities.

Money Market Certificate:
The account where a minimum deposit of $10,000 can earn you a rate of interest equal to the 182-day Treasury Bill rate in effect at the time of issue. The six-month certificate federal regulations prohibit the compounding or interest during the time of the deposit.

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The account for tax free savings. Minimum deposit of $500 with a maturity of one year. The annual investment yield is equal to 70% of the average investment yield for 52-week U.S. Treasury bills. Issued through December 31, 1982.

Individual Retirement Account (IRA):
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taxes on that part of your income nor on the interest which accumulates until your retirement.

Information is also available on SEPP and KEOGH Pension Plans.

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STEWARDSHIP BANK OF OREGON

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SMALL BUSINESS OWNED

The Stewardship Bank has a strong commitment to the free-enterprise system that is the back-bone of America. This commitment extends itself directly into the mainstream of free-enterprise, small business.

The 1980 White House Conference on Small Business and the 1980 Oregon Governor's Conference on Small Business have identified capital on the single most restrictive factor for the establishment and expansion of small business.

The Stewardship Bank is committed to making sound loans for the purpose of establishing and expanding small business. Loans for facilities, equipment, machinery, supplies, materials, working capital, receivables, inventory, contracts, energy conservation, education and other special applications will be considered.

The Stewardship Bank is committed to the three "C's" of credit for determining *"Creditability,"* Capacity, Credit and Character. Our officers can and will establish long term relationships with clients.

The Stewardship Bank is committed to service. Because bankers are managers of your deposits, we intend to provide you with contemporary and valuable assistance for success. The growth of small business and small banks depend on each other.

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Many Angry Customers Wage Prime Battle Against Banks

By JOHN CUNNIFF
AP Business Analyst

NEW YORK — A lot of people are angry at their banks these days, such as Bob Loughlin of Portland, Ore., Jackie Kleiner of Atlanta and Joe Pat Downs of Bardstown, Ky.

Loughlin got angry when, he says, a big bank foreclosed its loans to his firm and threatened to liquidate it. Kleiner got angry when, he says, he was badly overcharged on a loan. And Downs too.

Loughlin raised a todo with regulatory officials and in court, then helped form a bank for small businesses. With evangelical zeal he denounces "greedy" big banks and "phony" prime interest rates.

Kleiner, a business professor and attorney whom Bob Loughlin considers the patriarch of the angry activists, got incensed when, he says, his bank charged him on the basis of a prime rate that wasn't prime at all. His loans, says Kleiner, were supposed to cost one percentage point over the prime rate, which an America Bankers Association book calls "the rate charged the largest and most credit-worthy customers."

Kleiner then discovered what the Federal Reserve Board and the House Banking Committee now know, that commercial banks have been posting "prime" rates much higher than rates they gave to certain customers.

He sued, claiming the First National Bank of Atlanta engaged in fraud and racketing activities. He seeks double the $30,900 interest already paid, plus damages. The case is pending. So is a growing list of cases.

Kleiner, in fact, is involved in seven other suits, the latest one in Portland, where in conjunction with other attorneys he is suing First Interstate Bank of Oregon for allegedly overcharging his client.

One case already has been decided. A Kentucky jury ruled that Downs, a real estate developer, owed $104,000 less interest than United Kentucky Bank charged him, again because a loan was said to be based on the prime rate when, in fact, some customers received better rates.

That case is not ended though. It is being appealed, by Downs and his attorney, Kleiner, who now seek the addition of punitive damages against the bank and forgiveness of the entire $1.3 million loan.

The Loughlins, Kleiners and Downs, along with attorneys Henry Casey in Portland and Joe Merren in Atlanta, are having an impact. Many banks no longer quote "prime" rates, and avoid saying so in loan contracts. The Fed has expressed some concern. And so has the House Banking Committee.

The latter found that 60 percent of commercial loans by big New York banks in May 1980 were made at rates below prime. It said the average discount was four points off the prime rate posted by the banks.

It is for this reason that Loughlin, the chief executive officer of Western Food Equipment Co. and a lay leader of his Baptist church, refers to such rates as "the phony prostituted posted prime fib."

Aside from his talents as a successful business executive, Loughlin is possessed of a missionary's sense of purpose. And his purpose now is to correct what he sees as an outrageous injustice done to small business.

Loughlin's anger can be traced back at least to October 1977 when, he maintains, U.S. National Bank arbitrarily attempted to "liquidate Western — not its loan — but the Western Food Equipment Company."

Loughlin repeatedly sought an explanation off why a long-standing relationship should be ended so abruptly but, he said, he has never received one. He did, however, obtain new financing, at better terms, from Canadian Imperial Bank of Commerce. He survived; he won't forget.

He beseeched federal banking authorities to chastise U.S. National Bank, which after investigation they declined to do. He feels he got a runaround in his attempt to "assure Western and other Oregon small businesses that there will not be a repeat performance where a worthy business could be stamped out." He is considering litigation.

Meanwhile, he and associates helped form Stewardship Bank of Oregon, which he describes as "owned by small business people and committed to sharing profits with Evangelical ministries and Christian Schools."

"In our bank," he said the other day of Stewardship, which opened April 4, "we use the best and lowest rate." Small business people are welcomed; they are considered special people, not inferiors, he said.

While offering rates to small businesses 1.5 points below the "phony prime," he says, the new bank still was able to report an operating profit for September. Loughlin is pleased, but hardly appeased.

He is determined to continue the battle. The issue, he said, is big business versus small business, especially in regard to financing. "There can be no sacred cows living above the regulations," he said.

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US bank loses court action over charging high interest rates

IT IS not everyone who can work up an evangelical fervour about bank interest rates. But businessman Bob Loughlin has a canonical cast of mind. He believes that even the infernal regions beyond the bank teller's window can be purified.

By ELISABETH WYNHAUSEN
NEW YORK

Over the telephone from Portland, Oregon, he sounded disconcertingly sincere. All he wants, he said, is for his local bank to change their "attitood". Otherwise, as is the custom in America, he will take them to court, and, with luck, to the cleaners.

His attorney Jackie Kleiner, who lives half-a-continent away, in Atlanta, Georgia, has already successfully sued one bank over its interest rates. A jury ruled that Kleiner's client, a real estate developer, owed the United Kentucky Bank $104,000 less than the bank had charged on a loan of $1.3 million. The loan was said to be based on the prime rate but Kleiner was able to prove that the bank charged its favourite customers several points under the supposed prime. The average Joe is not over-fond of the major banks, Kleiner said, delightedly pointing out that the banks invariably contended with "a hangman's jury".

In a show of chutzpah, Kleiner is appealing the favourable decision in the Kentucky case. He wants punitive damages and forgiveness of the entire loan. "We have everything to gain and nothing to lose," he told The National Times. Kleiner is a professor of management at the Georgia Institute of Technology, and maintains his law practice. But in the American context he counts as a dedicated campaigner. He first sued a bank over its interest rates 18 months ago, and is now involved in 10 such cases. "I call it my Bank-of-the-Month Club," he said.

On this issue, he was his own first client, and, in a case that is yet to get to court, is suing the National Bank of Atlanta over its definition of the prime rate in a contract for a real estate loan. The contract said he was paying interest of 1 per cent over the prime rate, according to a handbook of the American Bankers' Association, it is "the rate charged the largest and most credit-worthy customers."

But Kleiner discovered that his bank "was making loans to Coca-Cola and other major corporations as much as five points under the prime."

Since he started a fuss about it, a Congressional committee on banking investigated and found that 60 per cent of commercial loans by major New York banks were offered at rates below the prime.

"They give it to 'em wholesale," Kleiner told The National Times. "It means that consumers and small businesses are subsidising large corporations."

The banks have responded with alacrity to what Jackie Kleiner calls his "crusade". "In several cases we've had settlement offers from large banks – they're willing to reduce the (interest) rates down to the 'federal funds rate' or the 'federal reserve discount rate', both of which are below the prime.

"The House Banking Committee issued a report condemning the deceptive prime rate practices of the 10 largest banks in the United States ..."

Kleiner and his small band of activists have been most effective on the east coast of America, where banks are changing their contract forms, to slide around the old definition of the prime, usually described these days as a posted rate.

"But in Oregon they hadn't heard about it," said Jackie Kleiner.

In Oregon, Bob Loughlin, a lay leader in his Baptist church and a man of faith, was sufficiently outraged about what he saw as deception by the banks to call their official lowest rate "the phony, prostituted, prime fib."

The chief executive officer of the Western Food Equipment Company (an outfit which manufactures and distributes food processing equipment), Loughlin owns 35 per cent of the stock.

He became disillusioned about bankers' habits when the US National Bank arbitrarily tried to foreclose on his loan, or, as he puts it, "liquidate" the company. He sees the action as characteristic of the way major banks treat small businesses, and said, of the details of the matter, "We have the potential for a Watergate type experience here, Elisabeth."

He resolved his immediate problem by taking a loan (at a better rate of interest) from the Canadian Imperial Bank of Commerce, but is still waiting to see if his old bank offers him an explanation and apology.

Because Loughlin was so incensed at the cavalier treatment of small businesses by the larger banks, he started up a rival outfit, the Stewardship Bank of Oregon, and it opened a few months ago. "We only have small business people on the board," he told The National Times.

The 350 stockholders of the Stewardship Bank are also believers of the other sort-all are evangelical Christians, and have agreed to a tithe. Ten per cent of the bank's profits will be handed over to support the activities of evangelical churches and related schools.

The Stewardship Bank gives small businesses loans at one and a half points below the "phony" prime. Rendering unto Caesar the things that are Caesar's, the bank was nonetheless able to report an operating profit last month.

Labor study accuses the Qld party of laziness

April 5, 1982

Western FOOD EQUIPMENT CO.

UP-DATING OF PROGRESS IN PROTESTING THE "PHONY PROSTITUTED POSTED PRIME RIB"

1. Please see the enclosed list of 11 law suits already filed with a current estimate of 1 new case to be filed each week.

2. The litigation involving United Kentucky Bank and Joe Pat Downs which had received the support of the Nelson Circuit Court jury as reported in the "Courier-Journal" as per the June 28, 1981 article enclosed and as reported in the Wall Street Journal of July 7, 1981 has now been settled with the foregiveness of loans and cash to be paid totalling over $1,000,000. The accuracy of this report has been confirmed through my contact with Jim McAfee at the Board of Governors of the Federal Reserve in Washington D.C.

3. Another settlement has been reached in the $250,000 category involving George Billings at Provident Credit Corp. versus First Pennsylvania Bank and the U.S. District Court. I talked personally with George Billings March 26th regarding this case.

4. Please be aware of the article "a small business man challenges the big banks" as the INC magazine covered in their March 1982 issue. This inturn continues to educate more small business persons regarding the "prime farce".

5. The John Cuniff nationwide Associated Press news release from last December continues to be triggering additional coverage including the enclosure from the Tacoma, Washington News Tribune of March 21st.

6. Gale Rosenburg of the Tampa Tribune was building on the John Cuniff report for a lengthy up-dating on the prime rate problem due for publishing April 4th.

7. The continuing concern of the small business person for excessive interest costs has been registered during my personal contacts with Jim McAfee at the Federal Reserve in Washington March 31st and April 2nd. We would like to look upon Jim as an ally in our request for "truth in prime" and therefore reduce interest expense to more informed members of the small business community. He had been interested in the status of the litigation and upon verifying the settlements reached stated that "the bank attornies were not bubbling".

8. It seems an unfortunate fact that the response to the House Banking Committee chairman St Germain request for replacing the "prime" term with a more honest terminology has been ignored by the banking community and apparently only when there is litigation filed and then cash paid is there any type of sincere attention to the concern of the Congress and the small business community.

9. The success of earlier litigation and the repeated examples of business failures because of excessive interest costs undoubtedly will be encouraging the filing of additonal litigation.

10. It is our understanding that additional class actions are being prepared in Oregon through Henry Carey and in conjunction with Jackie Kleiner's experiences.

11. My personal interest is that we simply have attention to the request of the House Banking Committee as per their report of prime rate abuse by larger banks and I would request support of the recommendations in the enclosed April 29, 1982 news release from Congressman St Germain.

Bob Laughlin

BL/erg

LAW OFFICES
KLEINER & MERREN
[illegible]
2575 PEACHTREE ROAD
ATLANTA, GEORGIA 30305
[illegible]
CABLE - KLAW

March 22, 1982

Mr. Robert Laughlin
Chief Executive Officer
WESTERN FOOD EQUIPMENT COMPANY
1924 N.E. 181st Avenue
Portland, Oregon 97230

Dear Bob:

In response to your telephone call of today, the following prime rate cases, as best I can tell, have been filed throughout the United States:

1. United Kentucky Bank, Inc. v. Bardstown Shopping Center, et al; Civil Action File No. C-80-CI-094; Nelson Circuit Court; Bardstown, Kentucky.

2. Joe Pat Downs, et al v. United Kentucky Bank, et al; Civil Action File No. C-81-0366L(B); U.S. District Court for the Western District of Kentucky (Louisville, KY).

3. Kenneth and Alberta George v. United Kentucky Bank, et al; Civil Action File No. C-82-002-L(A); U.S. District Court for the Western District of Kentucky (Louisville, KY).

4. Wilcox Development Company, et al v. First Interstate Bank of Oregon, N.A., et al; Civil Action File No. CA-81-1127-BE; U.S. District Court, District of Oregon (Portland, Oregon).

5. A. C. Distributing Co., et al v. First State Bank of Oregon, et al; Civil Action File No. CA-81-1128; U.S. District Court, District of Oregon (Portland, Oregon).

6. Provident Credit Corporation v. First Pennsylvania Bank, N.A.; Civil Action File No. CA-82-0311; U.S. District Court, Eastern District of Pennsylvania, Philadelphia Division.

7. Morton D. Willcutts, Jr., et al v. Jefferson Trust and Savings Bank of Peoria, et al; Civil Action File No. CA 81-1153; U.S. District Court, Central District of Illinois, Peoria Division.

8. New Jersey National Bank v. Vernon B. Bennett, et al; Civil Action File No. L-4204-81; Superior Court of New Jersey: Law Division Mercer County (Trenton, N.J.).

Western FOOD EQUIPMENT CO.

May 10, 1982

THE BRUTAL FACTS OF LIFE REGARDING PRESSURES ON SMALL BUSINESS AND SOME OF THE CONSTRUC TIVE ALTERNATIVES - SMALL BUSINESS PEOPLE FORMING THEIR OWN BANKS.

The New York Times lead story by Robert Bennett of April 25th, "How the Banks are Squeezing Small Business" is a very relevant report, and we encourage your reading. It also ties in well with the earlier report of "business failures spreading", which shows a wide range of failures geographically and by small business in retail, wholesale, manufacturing, services and construction.

The reprint from the April, 1982,"The Wholesaler" manages to describe an attempted liquidation by a large bank of a 29-year old small business; however, in this case, the U.S. National Bank of Oregon failed in its liquidation attempt, and we really appreciate the reality that an even larger bank, Canadian Imperial Bank of Commerce with a more willing spirit of cooperation with small business, felt Western Food Equipment Company was worthy of their confidence. The National Association of Wholesaler-Distributors felt the story also was worth sharing, and their January, 1982, reprint is also enclosed - and provides some of the detail of how Stewardship Bank of Oregon came into existence.

The United States Chamber of Commerce "Washington Report" has been gracious in their recognition of the uniqueness of the concept, and this in turn has led to the article in the May, 1982 "Nation's Business" which is enclosed.

Obviously, there is a problem for the small business community, and obviously one of the solutions is for those same small business persons to form their own banks to not only help themselves, but perhaps more importantly to help other small businesses in their community. A review of the record with Stewardship Bank of Oregon will show ver little, if any, "self-serving" for SBO organizers and directors,while you will find many examples of fair loans to Stewardship Bank owners and depositors.

Every week we receive inquiries from small business persons who have learned of the concept through the media and who are interested in exploring their own bank. We also receive calls regularly from the media interested in an updating of, "How is Stewardship Bank of Oregon doing?". Please see the enclosure that summarizes the excellent deposit growth of Stewardship Bank of Oregon measured against 21 other banks in the tri-county area. There is every reason to project that deposit growth in the next yea will exceed that of the initial year, as there have been many "watching and waiting" to see if indeed the idealistic principles of Stewardship Bank of Oregon are going to be carried out. THEY ARE!!!!

While we are extremely sorry for the problem that Bob Bennett has so accurately described, we are grateful for the options of how a small business community is in a posi tion to help themselves. We also acknowledge and deeply appreciate the number of inde pendent community banks who are already committed to sincerely serving the small busir community because they are indeed a "small business bank" themselves.

Bob Laughlin

BL/rr

THE KANSAS CITY STAR.
Wednesday evening, March 10, 1982, Main Edition, 42 pages

Kansas City Star, March 10, 1982

Small-business bank fights prime war

By Diane Stafford
Business Reporter

Robert E. Langdale, chief executive officer of a small food equipment company in Portland, Ore., was so disturbed with the service he was getting from his bank that he decided to start his own.

Mr. Langdale's effort, Summit Bank, opened on the bottom floor of a downtown office building in Portland in 1980.

The bank, which marks Thursday its first anniversary, is designed to operate especially for small businesses, Mr. Langdale said.

In a recession unheralded for later today, he plans to present his 83 employees with a bonus equivalent to their salaries for one week. Mr. Langdale said the bank's assets had grown from $2.4 million to $6 million in the first year.

Yesterday there will be an open house at the bank's new quarters in a downtown office building. Mr. Langdale credits the move, which will double the bank's space, to its growth in its commitment to help owners of small businesses find money to expand their businesses.

At least twice this year the bank has raised the interest rate it charges on its prime loans.

Eighty percent of the time we have been able to make it one point below what it call the primary rate," Mr. Langdale said in an interview.

"We don't even like to use the prime lending rate. We often call it a 'ticket rate' on most of our loans, which is comparable to the announced prime at the big banks."

Mr. Langdale said he began toying with the idea of starting a bank in August 1977, but it wasn't until after the White House Conference on Small Business in January 1980 that the idea began to take shape. Then, he found many other small business owners who were concerned about their problems of credit difficulties and high interest rates in contact on a one-to-one basis with them.

Although banking laws require Summit Bank to make loans that reflect the source of the deposits — and all customers of the bank must live or have businesses in the Portland area — the bank's directors are committed to making small loans and loans at below-market rates.

"We don't want any of our people to be half our clients to stay small," Mr. Langdale said. "We want to help them grow and prosper. We're willing to lose money on the bank in the early years to help our clients."

Last year, the bank donated $1 of its profits to charity for each $1,000 in deposits. This year, the bank's directors have decided to increase that to $2 for each $1,000 in deposits.

The bank's deposits have grown to about $7 million.

Although Summit Bank officers have not shown other banking groups to set small business loans, they are willing to share their experiences with other banks, Mr. Langdale said. He has received positive reactions on Capitol Hill, where several members of congressional staff members have visited Summit Bank to see how it operates.

Summit Bank is a member of the Federal Deposit Insurance Corp. and its deposits are insured up to $100,000 each. It is a state-chartered bank that offers checking accounts, NOW accounts, savings accounts, money market certificates, certificates of deposit, all-savers certificates, participations in several loans, and a variety of other services.

Washington Report

The Weekly Business Advocate Newspaper More Than 775,000 Paid Circulation onday, April 27, 1982

Please send information on how to develop stewardship banks. I have had inquiries from small business people requesting this information and would like to share it with them.

Lonar Birch

LONAR BIRCH
Regional Advocate

SBA
U.S. Small Business Administration

Small-Business Group Starts Its Own Bank

CONFIRMATION OF SMALL BUSINESS SUPPORT PHILOSOPHY OF STEWARDSHIP BANK OF OREGON

We are one of the owners of the Stewardship Bank that recognize and respect the importance of the small business person in the economy of our community, city, county, and country. We are aware of grass roots groups expressing concern for the survival as well as the growth of small business. Examples include the 1980 White House Conference on Small Business and the December 1980 Oregon Governor's Conference on Small Business Problems. While it is only one constructive alternative to the problem, we as SBO owners want to be part of aiding small business in capital formation and capital for expansion.

We agree with the philosophy of SBO committing ourselves to banking policies that provide above average assistance to qualified small business men and women. We agree with maximum cooperation with the Small Business Administration (SBA Guaranteed Loan Program) and will encourage our Directors, Management Team and Loan Committee to support that commitment. If Management and Directors would recommend cooperation with qualified small business on a preferential basis supplying loans at national "prime" rate or less we will support that policy.

We agree with the commitment of Stewardship Bank owners reflecting a majority of small business persons on the Board of Directors. We recognize and support the small business experience of the following Directors:

Lou Beres, Lou Beres and Associates - Real Estate Brokerage.
Dan Clausen former small business person and experienced in the general business community.
Greg Hughes - involved with several small businesses.
Bob Laughlin - CEO of Western Food Equipment, a warehousing wholesale distributor for food processing and food service products.
Milli Laughlin - Former Administrative Specialist for Western, Educator, and presently Personal Banking Counselor at SBO.
Bob Poole - Owner of Pig 'N Pancake Restaurants in Seaside and Astoria.
Roger Rutherford - Director and Senior Vice President, Operations, Cliff Wilson Company, storm window manufacturing and installations.
Lynn Wallace - President and General Manager Western Food Equipment Co.

The remaining Directors while have had less direct small business experience are committed to this statement:

John Gustafson - Christian Education Director, First Baptist Church, Salem
Dick Wells - President & Chief Executive Officer, Stewardship Bank of Oregon

We support the recommendation that future Directors will be considered influenced by their small business background and commitment. We encourage a policy of selecting owners of the Stewardship Bank of Oregon in such a manner as to reflect an ownership which is currently active in or sympathetic to small business as indicated by our signatures.

We encourage the Management and Directors to seek ways to provide sound loans for innovation and worthwhile small business projects. In addition we encourage them to find solutions to areas of need in the small business community. We also encourage the Community Business Advisory Council concept where bank Directors and Management will meet on a regular basis with small business leaders in our metropolitan trade are.

Signature_____

Signature_____

Small businesses pushing for notice by Washington

NEW YORK (AP) — Fired with "a collective passion that will make Proposition 13 pale by comparison," small-business people are the latest to congregate in Washington to have their case heard.

"I don't think they will settle for anything less than results," said Arthur Levitt Jr., who applied the "passionate" tag to the small-business people who, he said, were fighting for their lives.

Levitt, chairman of the American Stock Exchange, made his comments as head of a commission that in one year held 57 hearings leading to this week's White House Conference on Small Business.

The business people, representing companies with one or two employees to those with hundreds, are fired up, said Levitt. Fired up about their lack of recognition, about inflation, their inability to attract a fair share of capital, about taxes, paper work and regulation.

Being practical people, their long list of grievances is nevertheless exceeded by their total of corrective proposals, gathered from 30,000 business people who attended the regional meetings.

Some 1,500 of them will attend the Washington conference Sunday through Thursday. Delegate voting will reduce opinions to 60 proposals and then to 15 priority recommendations to be made to the president.

The biggest fear of the delegates, Levitt said in an interview, is that after all their effort and passion they will go back home and legislators will do nothing.

"I hope a response will come out of this conference," Levitt said. "I think the White House will follow up." But there is no assurance, or if there is, it is that the intensity of delegate feeling can hardly be ignored. Nor can their increasing political sophistication.

Several local groups and the Small Business Association now keep legislative scorecards, and when November comes around they spread the word about who is and isn't a supporter.

Some small business advocates hope that out of the conference there will emerge a permanent organization, something that can be used to keep pressure on Congress and the White House.

Is "fighting for its life" too extreme a description of the predicaments of small business? Small-busines people don't think so. They say they are being crushed by Big Business, Big Government and Big Unions.

They maintain that too often they aren't even recognized as a distinct constituency, and that as a result their special needs and goals are ignored by legislators.

They argue that they are excluded from many capital markets simply because they are too small.

The Sunday Oregonian

BUSINESS

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October 28, 1981

Western FOOD EQUIPMENT CO.

ACCUMULATING SOME OF THE FACTS REGARDING SMALL BUSINESS RECEIVING LESS RESPECT AND CONSIDERATION FROM BIG BANKS THAN WHAT WOULD APPEAR FAIR.

1. When the White House Conference on Small Business met in January of 1980 capital formation was the top priority among the delegates.

2. Arthur Levitt, chairman of the board of the American Stock Exchange in New York stated the problem of the small business community very well in an article that appeared in the Portland Oregonian during the time of the WHCSB including comments regarding "fighting for their lives" against the pressures of big business, big government and big unions and referring to the lack of access to commercial credit because of their size.

3. These are general principles that continue to be valid as specific examples are cited.

4. Western Food Equipment Company may be one of the "classics" of fighting for its life against the big businesses involving U.S. National Bank and perhaps others who set out to liquidate Western in 1977.

5. Henry Carey is familiar with the procedures and at times questionable policies of big banks in Portland and has pointed out that smaller businesses are liquidated literally every week by big banks and the only item unique about Western is that they survived.

6. There are indications of larger banks who want to eliminate small business credit lines in the area of $300,000 with the explanation that the same among of "servicing" is required for loans of $1,000,000 and the "net profit" is more attractive from the larger credit lines with medium sized business.

7. Some larger banks have layers of administration and loan committees so that attempts to have loan applications considered on personal character and "eyeball compatibility" is denied.

8. As some smaller independent banks are taken over by larger banks the personal touch and personal acquaintance is lost to the disadvantage of the smaller business.

9. There are those who project that Interstate banking is inevitable and that one "fall out" would be that 14,000 commercial banks in 1981 might be reduced to 3-4,000 by 1985.

10. Foreign banks continue to express interest in smaller, medium - and larger American banks and frequently offer owners a value beyond book or market value that is literally impossible to turn down. A study needs to be made of how extensive this infiltration of American banks has become.

11. Where there had been a preferential two tiered interest rate schedule in the mid-1970's that provided lower interest rates to smaller businesses this policy has since been discarded.

12. There was a time when the United States Small Business Administration published a list of some 127 banks that offered special interest rate packages often below the National prime to smaller businesses. That procedure apparently has changed and the lists are no longer available.

13. There is adequate documentation to show that small businesses are now being charged points above the "prime" while unfortunately beginning in May of 1980 it has become increasingly clear that larger corporations have been granted discounts by larger banks as much as six points below the "prime" which traditionally has been understood and definied as the best commercial business loan rate for the most credit worthy corporate customers.

14. It would appear that the trend is getting worse and that there is a continuing lack of respect in the banking circles for the value of the independent small business.

15. What will be the projection for access to credit from commercial banks as the big banks get bigger and the smaller banks become less numerous?

16. Small Business Administration reports that high interest costs have become one of the leading factors in a accelerating pattern of bankruptcies on SBA guaranteed loans.

Bob Laughlin

BL/eir

Western
FOOD EQUIPMENT CO.

November 4, 1981

THE IDEAL TYPE OF BANK FOR A SMALL BUSINESS PERSON TO ASSOCIATE WITH AS PART OF HIS LONG-RANGE PLANNING

1. A bank that has a clear-cut written policy agreed to by owners, directors and management team that there is no higher priority in the bank philosophy than to specifically meet the need of the qualified small business community.

2. Meeting the broad need of the community as represented by small business persons considered to be equally important with profitability for the bank owners and compensation of bank management team. If the bank properly takes care of its customers, the customers through reciprocation will take care of the need of the bank for reasonable profits.

3. A bank that wants to maximize continuity of bank management and bank loan officer personnel so that a minimum of time is required for small business persons to "start over" with a new manager or loan officer.

4. A bank that is consistent with the commitment when receiving its state charter that it will "meet the broad need of the community".

5. A bank that is honestly committed to the statement of its organizers that it has not been organized for the purpose of developing it to a level where the bank is "offered for sale to the highest bidder before or after the commitment period has expired with the bank superintendent.

6. A bank whose owners, organizers and management anticipates that there may be opportunity for sale at excellent return on investment for owners, however, offers through Interstate banking and foreign banks to acquire this independent unit community bank would be of little or no interest.

7. A small business oriented bank owned by small business persons that would be open to cooperating as a correspondent bank with other small business oriented banks that may desire to open as part of a series of similar unique banks scattered all over this country. Willing to cooperate with accommodation loans for start-up capital and any other correspondent banking service to encourage the broad concept expanding.

8. A bank that periodically up-dates and renews its written statement of small business philosophy and support and presents it for ratification to its owners.

9. A bank able to answer positively the probing and piercing questions that the small business community is asking today as part of maximizing its foundation for long-range planning assuming maximum cooperation and accessibility to adequate capital at a reasonable interest rate.

0. A bank that openly states its best commercial loan business rate and

cont. makes no attempt to hide a discounted rate to larger corporations below the publicaly announced "prime".

A bank that is committed to openess and honesty in disclosing its loan pricing policy in line with the encouragement for accurate information available to the public as recommended by the House Banking Committee led by Congressman St Germain and their report of April 30, 1981 encouraging "truth in prime".

A bank who reviews annually the members of the board of directors to be sure that their foundation and performance has reflected support of the overall bank philosophy of cooperating in a unique way with the small business community.

A bank where small business persons are able to be part of the ownership where preferably there is a broad base of small business owners perhaps with no more than 5% stock held by any one individual and where the commitment to the bank philosophy/maintained through unanimity of support to that philosophy rather than reflecting the personal interest of a small group of individuals conceivably more concerned for personal profit or other advantage.

A bank that if it is able to function as a Sub Chapter-S small business corporation bank with only one taxation at the personal income rate would utilize that normal corporate tax saving to provide more services and more reasonable interest cost to the small business customers.

Laughlin

1

Oregon's **Small Business** Counsel

BARometer

350 Airwise St. S.E. Salem, OR 97302 (503) 585-5846

Volume 3, No. 3 March, 1981

OSBC Member Bob Laughlin— Solving Small Business Problems

(the following excerpt is taken from Finance Magazine)

Borrowing from employees and friends can be an effective way to beat the current sky-high cost of getting a corporate loan from a bank.

Chief Benefit: The company pays an interest rate several points below the corporate loan rate. *Bonus:* Employees are more personally involved with the company's operation. They'll take a greater interest in productivity. There's a stronger atmosphere of trust between management and workers.

To Sell The Idea To Employees: Before the growth of money market funds and bank certificates, companies could simply offer interest rates above the 5¼% passbook savings rate. Today, it may be necessary to offer a higher yield than the employees could make by investing in the money market.

How Employee Borrowing Works For One Particular Company: Western Food Equipment, a food processing and packaging firm, had relied on loans from workers and friends for supplemental funds ever since it was formed in 1948. But the company moved into employee borrowing on a large scale in 1974-75, when it needed cash to research and develop a new food processing technique. Its bank at the time refused to expand its line of credit. *Instead:* The company lined up 30 lenders, (one-third were employees), and raised $300,000.

Details: Interest rates are adjusted with money market movements. They also vary according to the size and time length of the loan. Last year the interest schedule varied from 10% to 13%. Lenders withdraw their money by giving notice 60 days before the maturity date of their loan.

Goal: Replace its line of bank credit entirely with loans from employees and friends. (see related article on Stewardship Bank).

Stewardship Bank of Oregon Opens Its Doors

On March 13, 1981 **Bob Laughlin** will realize his dream and culminate eighteen months of tenacious effort — Stewardship Bank of Oregon will open its doors. Stewardship Bank is a tribute to OSBC member Bob Laughlin's persistence. Bob, a Portland businessman, became disenchanted with the shabby manner in which his local banks treated him. To resolve his problem, he decided to **form his own bank.** The move could revolutionize the banking industry.

Stewardship Bank will be a small business bank and will attend to the special **needs of smaller firms** and lend at **lower rates** than commercial banks. The typical and traditional approach to banking is to maximize profits in the shortest time frame while incurring the lowest expense possible. As a result, small businesses have had to put up with demanding terms and often unaffordable interest rates.

Bob feels differently about the responsibilities of banking institutions. He feels immediate short term profits should take a back seat to the larger responsibilities of maintaining **customer satisfaction** and a **healthy economy.** Stewardship Bank will reflect these priorities and deal from a more traditional small business philosophy of emphasizing the development of solid long-term relationships and steady growth.

No big business representatives will sit on the Board of Directors of Stewardship Bank and small business customers will find Stewardship Bank more understanding of the problems of small businesses than the traditional banking community.

Although banking laws will require Stewardship to make loans reflecting the source of its deposits, its organizers maintain they never want owners to tell them they must stop making small business loans because a higher profit can be earned elsewhere.

OSBC is proud of the efforts of Bob Laughlin and his friends and associates for bringing us Stewardship Bank of Oregon. His dedication to small businesses and their problems is warmly appreciated. GOOD LUCK!

The Wholesaler

DISTRIBUTION VOICE OF THE PLUMBING-HEATING-AIR CONDITIONING AND REFRIGERATION INDUSTRY

Bob and Milli Laughlin (left) pose in front of the new Stewardship Bank of Oregon facility with (from center to right) Western Food Equipment Co. Chairman Erwin Laughlin; bank President Dick Wells; and bank director Lynn Wallace, also an officer at Western.

Wholesaler leads other small business people in founding bank

By Mary Ann Falkman
Editor

PORTLAND, OR—In July 1977 the local branch of U.S. National Bank abruptly and without explanation decided to terminate its six-year banking relationship with Western Food Equipment Co., Portland, OR. The wholesaler had 30 days to locate a new, cooperative bank. But with the company's on-going change to computerized accounting, up-to-date financial information could not be available on such short notice. Western's CEO, Robert Laughlin, realized that his 29-year-old company was facing imminent closure.

The drama ended when Canadian Imperial Bank of Commerce—the seventh largest bank in North America—agreed to issue a greater line of credit at less interest to the Portland wholesale firm. But the saga of Portland's small business pioneers had just begun.

From an idea conceived in that summer of 1977 came the April 1981 birth of Stewardship Bank of Oregon, a full-service bank founded by, owned by, and operated by small business owners or others sympathetic to their needs.

The bank's owners sign a confirmation of the small business support philosophy of the Stewardship Bank of Oregon. "We back up in writing the things we say we are," claims Bob Laughlin.

Basically, the owners pledge to aid small business in capital formation and capital for expansion. They encourage the bank's management "to seek ways to provide sound loans for innovation and worthwhile small business projects. In addition, we encourage them to find solutions to areas of need in the small business community." To that end, the managers meet regularly with small business leaders in the metropolitan area within a community business advisory council concept.

Just six months after its grand opening, by September 1981, the bank had achieved a status of profitability—a feat that normally takes about three years. Stewardship Bank now has deposits of over $4 million from 1,200 depositors. It has granted nearly 300 loans, most of them to small businesses, at an average rate of 1 point BELOW prime rate.

Funding for the bank was arranged through Canadian Imperial Bank of Commerce, which provided organizational loans to the bank's founders and the loan for the bank's permanent facility built adjacent to Western Food Equipment's warehouse. After Stewardship Bank capitalized, the organizational loans were paid out of capital. About the only expenses during the set-up period were those of a few key bank personnel. Legal expenses were kept at a minimum since no attorney was retained; lawyers were hired on an individual consultation basis only.

The Oregon state superintendent of chartered banks, Jack Olin, has conducted two routine audits of the Stewardship Bank, and the FDIC has reviewed the bank's loans. In both cases, the new bank's deposits and loans were rated "above average," says Bob Laughlin. And, this is in spite of the fact that Stewardship Bank has granted loans to businesses who were refused elsewhere.

Laughlin recently noticed an article in the newspaper about a 67-year-old auto dealership that had been refused help on a SBA loan by a larger bank. "We are willing to try to make an application for the company," Laughlin said. "We possibly have a chance to save that business."

In that same week, the owner of a relatively new small business came to the Stewardship Bank for a loan, saying he had been refused at other banks because he did not have a long enough track record. "We can help him too," Laughlin noted.

Profits: their goal too

Stewardship Bank of Oregon is not a non-profit service organization, however. Its stated goal is to make a profit, up to 30% of which is donated to Christian schools and groups.

The "tithing" aspect of the bank's philosophy is its second unique feature. Under current law, a business may donate 10% of its profits to a charitable fund or organization. Stewardship Bank also pledges to donate up to 20% of its dividends, if the owners agree.

"Small Christian colleges have needs similar to those of small businesses," Laughlin explains. The bank's current owners represent 22 different religious denominations.

Many groups across the country have expressed interest in forming a bank like the Stewardship Bank, and Laughlin says that 90% of them are interested in both the small business and evangelical philosophies. The other 10% are not interested in the religious angle; but Laughlin points out that the 10% donation from profits to any community charity would be "fantastic advertising."

The Stewardship Bank itself has already received phenomenal publicity, including a multitude of local newspapers and business publications, the *Wall Street Journal*, three articles in *Inc* magazine, several more articles over the AP wire, and national television coverage.

Although Bob Laughlin has acted as chief spokesman for the bank as one of its directors, his full-time duties are still as CEO at the wholesale food equipment company. His wife, Milli, is the bank's personal banking counselor as well as a director.

Innovation as a way of life

Finding unique sources of capital for Western Food Equipment Co. actually started almost 35 years ago. The wholesale firm has borrowed money from its employees for many years, and it still does so. Under the company's "private placement" program, 31 employees and friends have about $400,000 on loan to Western, which is paying 13-16% interest, depending on the length of the loan.

Western has pledged in principle to keep its security in its property to back up those unsecured loans. The wholesale firm's facility is valued at $1.4 million, and the company has an equity of $800,000 or twice the amount of the outstanding loans.

Laughlin says that the Stewardship Bank officers sometimes recommend a private placement plan to small companies in need of capital. "To be blunt, if the employees don't trust the man, the bank shouldn't trust him either," Laughlin says.

It is highly unusual for any bank to recommend other sources of capital to a small business, Laughlin says. In fact, he admits, Western's long-standing practice of borrowing from employees—which was stepped up when the Security & Exchange Commission changed its ruling to allow more than ten individual loans—may be a major reason U.S. National Bank decided to terminate their line of credit. □

Does 'prime' mean best? That depends . . .

By definition, the prime rate is the lowest interest rate charged to a bank's most preferential customers.

But today that just isn't so. For several years now, banks have routinely issued loans to large customers at rates below the stated prime. The majority of small businesses can hope for a few points over prime, at best.

But that practice may change soon. An Atlanta attorney and real estate investor, Jackie Kleiner, has filed a class-action suit in federal court, charging First National Bank of Atlanta with consumer fraud for lending him money at a rate tied to the prime when it had loaned money to others below prime. Other suits followed, including a victorious decision in a Kentucky county court. But Kleiner's case, which may be decided late this spring or summer, may have far-reaching impact because it is a class-action suit and because it will be decided in federal court. Kleiner is asking for six years of interest payments, and he has vowed to take the case to the Supreme Court, if necessary.

The prime rate was adopted by the banking industry in 1933, at a time when few people were interested in (or could) borrow money. To prevent cut-throat competition, the banks set 1 percent as prime, or the lowest rate. Although the prime fluctuated over the years, it retained its image of the "lowest rate."

Lending at rates below prime did not become common until the late 1960s when the interest rates began their rapid ascent. Banks today prefer to define the prime as the average measure of how much it costs the bank to get money to lend. That measure includes the bank's profit. Basically, Jackie Kleiner, and the others who have filed similar suits, charge that the banking industry tried to change the rules of the game without telling the players. □

The Oregonian
MAY 17, 1980

BUSINESS MONDAY

Stewardship Bank puts its money where its heart is

By STEVEN CARTER
Oregonian Staff Writer

STEWARDSHIP BANK — Robert Wells, president of the Stewardship Bank of Oregon, says the Eliot Multnomah County bank, oriented to the needs of small businesses, now grows ahead of conglomerates. After 10 months, deposits total about $4 million.

When the officers of the Stewardship Bank of Oregon say they are out to serve small business, they mean it.

The bank, open barely a year, was started by a group of small-business men. It started the future in the midst of hiring a small-business advisory committee that made the bank blend its loan policy to serve small shops and other businesses.

Most of the members of the board of directors are actively in small business [illegible] Richard Cole, bank president.

Additionally, some of the bank's 300-odd shareholders are small-business operators, and all small shareholders were asked to sign an agreement supporting the directors' intention to "aid small business in capital formation and capital for ownership."

The bank, which opened officially in March 1979, is in Multnomah Village and is an offshoot from Western First Bank on the other side of Portland. In terms of total deposits, the bank is small — $4 million, just barely, by comparison to the $1.5 billion of the First Interstate Bank of Oregon, the state's largest bank.

The bank's small-business orientation makes it unusual, but it is also one of the refinements that was learned by a group of evangelical Christians who have pumped $2 million into the bank's profits — when they vote — in Christian causes.

Stewardship Bank is not unique by any in its focus on small business in Oregon. It is one of [illegible] banks that have organized in the last five years — more than a few with a small-business focus, including Western First Bank and the Bancorp Building Co. A number of them have shown startling growth rates.

John Otis, state superintendent of banks, said that Stewardship has generally charged with the intention, and he suspects that if you talked to each group of new bank today, it would probably be laughing.

Otis said he doesn't buy the notion that the bank, [illegible] has put more money in the community, either in the big bank doesn't. Stewardship will put money to work wherever they can, he said, and if a small bank has current funds, it will invest them elsewhere in town, if that is where the return is best.

But Otis agrees with another opinion that small businesses — even those that they can give better service as banks. "Small banks are on the small," he said. "They don't have to send loan applications to the head office."

The founder of Stewardship Bank, Robert Laughlin, was motivated to start the bank in part because of small problems he encountered in dealing with a big bank, U.S. National Bank of Oregon. He left U.S. National, the former called it here in Western First Bank and Co., of which Laughlin is chief executive officer, and he had to search to find a new small money.

Relations between the banking industry and small business have been difficult for some time. As interest rates and capital have risen, small businesses have found it more difficult to get financial assistance to big business.

They also complain that, as banks grow and swallow smaller banks, the human, personal relationship between the banker and his customers often has gone by the board.

A lightning rod in the controversy was Bank One [illegible] with [illegible] ads in banks that boasts about their easy accessibility compared with [illegible] banks. Small-business operators complain that banks always have always been the prime rate for loans, with [illegible] limited rates before prime for big borrowers.

Bankers respond, however, that they are fully appraised by rising costs and that it costs just as much to service a small loan to a small business as it does to handle a big loan to a big business — and there only is more the business.

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shows the cost of failure is higher for small business than for big ones.

Yet, to at least some businesses, small business banks are worth every penny. A [illegible] of small banks after [illegible] endorsed by Gold Digger seems parts.

"When I tried to start my small business, I was turned down by five different banks in Portland," said Jim Stanberry, director of Downtown Travel Service of Beaverton. "All it had owned, I was prepared to risk. When I'm [illegible] I'll be back, ground up. I have to start my business over."

Unlike other banks, they looked at the potential of the business — not whether I owned any of [illegible]," he said.

After a slow period in January and February, he said, his business has started to take off.

"We have had a strong demand for loans," Wells said. "But even the start, we decided we weren't going to [illegible] my situation to the national prime rate. I'm a firm believer in using the base rate to the cost of your funds. Our normal business rate now is 16 percent, and I think that's still very competitive."

That figure is 1% points above the current prime rate, but Laughlin said that in many cases, the Stewardship Bank has been able to lend at lower prices.

And, he said, some loan policies a bank is borrowing rates, small-business people are interested in friendly service and good service. It's small that it takes the Stewardship Bank only five days to give an answer in regard to a loan, he said.

With about 20 years with the Bank of California in the back — he had risen to a senior lending officer — and [illegible] years operating small businesses, Wells said he knows the kinds of problems small businesses face. He has [illegible] from the Bank of California to work for Western Bancorp Capital and then for the Western Corporation for the Southwest in Denver.

He had known Laughlin, through a [illegible] acquaintance, and he joined the bank just before it opened in February 1979.

A significant number of the Stewardship Bank's deposits come from the Christian community, but the number of borrowers — roughly 1,000 — reflects a broad base of small business people who are not connected with business causes.

He said the bank "is pretty much an afterthought" in programming or marketing and he has been pleased by the demand for credit from the bank.

Despite the religious orientation of the directors, Wells said, "we don't ask any questions" to find out when people apply for loans about their religious affiliations or activities. Instead, it uses the [illegible] by The Dun & Bradstreet credit rating service and they rarely are interested in the religious activities of the borrowers. Wells said that most of the borrowers have had some trouble getting loans from other banks.

Laughlin said that the bank's [illegible] committee was formed to work with the bank mainly to help with [illegible] matters. When the bank opened in February, it was not a formal board, but developed a number of suggestions and ideas that the bank [illegible] Wells said. It is now a [illegible] with [illegible] on the Christian [illegible] and the Chamber of Commerce.

The bank was open to be in the center of [illegible] and [illegible] Wells said. It hasn't changed much in [illegible] and of the economy.

May 10, 1982

Western FOOD EQUIPMENT CO.

THE EXCELLENT PERFORMANCE OF STEWARDSHIP BANK OF OREGON IN GAINING DEPOSITS DURING THEIR FIRST YEAR OF OPERATION MEASURED AGAINST OTHER BANKS IN THE TRI-COUNTY AREA.

When you get out your magnifying glass and review the fine print of "the three county area response to the call for condition by the comptroller of the currency" which is attached you will find some excellent facts regarding the growth of the Stewardship Bank of Oregon.

1. Of the 22 banks reporting there were 8 that actually lost deposits during the year while Stewardship Bank of Oregon was moving to almost $4,000,000. In addition there were 9 reporting banks gained less than $4,000,000 through the year. Only 4 banks reported more deposit gains than SBO!!

2. The Bank of Milwaukie and Farmers & Merchants of Forest Grove had reported March 31, 1981 deposits slightly over $1,000,000 and SBO has already moved ahead of them with deposits of $3,925,000 even though our grand opening was April 4, 1981 with only a "soft opening" March 13th. SBO did not respond to the "comptroller call" at the end of the first or second quarter last year and therefore we are "really the new bank in town".

3. Of the 8 banks losing deposits during the year it is noteworthy that First Interstate Bank lost $111MM hardly indicating that the community is "turned on" by the "Interstate Banking theme". Oregon Mutual Savings Bank lost $32,000,000, Bank of California $12,000,000, Metropolitan Bank $3,000,000 and lesser deposit loses by the Independent Bank of Sandy, American State Bank, Canby Union Bank and Willamette Falls.

4. Of the 4 banks gaining more deposits than SBO 3 are so large that their percentage gain almost makes a poor comparision to that of SBO. Perhaps one of the most encoureging analysis would be that the small business oriented Beaverton Banking Company more than doubled their deposits with a gain of over $5,000,000 and I believe is a good example that Stewardship Bank of Oregon could at least double their deposits moving beyond $8,000,000 by March of 1983.

5. SBO is ahead of forecast in deposit growth and reaching profitability and measured against the above comparision we can be very pleased. "Most banks reported soft demand". The loan demand at SBO has been very strong and the ability, therefore, to be selective in choosing our loans is ideal.

6. Please note the key reference to Columbia Daily Income Assets increased by $21.6MM in the first quarter. A very sober report for the conventional banks in the tri-county area, however, the same loyalty of deposits that have allowed SBO to be moving ahead beautifully and "moving up the ladder" is going to continue in the years ahead.

7. I would say that almost by any interpretation you want to apply that Stewardship Bank of Oregon is doing great and this should be an encouragement to SBO owners and those potential new owners of additional stock at Stewardship Bank of Oregon.

THE OREGONIAN, MONDAY, MAY 3, 1982

Banks note slump in deposits, loans

By DONALD J. SORENSEN
of The Oregonian staff

The recession left its impact on Portland banks in the first quarter as deposits and loans both slumped from year-end totals, putting an end to a string of quarterly increases in 1981.

Deposits took the biggest drop, falling 6 percent from a record $9.5 billion at year end to $8.9 billion as of March 31. Loans declined about 2 percent, slipping to $7.26 billion from $7.4 billion, which was also a record.

Since the first quarter last year, loans and deposits had shown sluggish improvement in each quarter as they reached record totals at the end of 1981. But the trend was reversed in the first quarter as the impact of the recession became more noticeable.

For deposits, it was the worst showing in recent years. The March 31 total was only $67 million above a year earlier. Loans were 6 percent above the comparable period last year. The figures were reported by the banks in the three-county area in response to the call for condition by the comptroller of the currency.

The effects of the recession are showing up in loan activity in various ways. This is evident in flowing demand, a rise in marginal loans, an increase in loss provisions, more loans going unpaid and closer scrutiny on loan applications.

The larger banks were able to increase their loans in the first quarter, but some of the smaller banks — such as Clackamas County, Canby Union, Metropolitan, Independent in Sandy, Lewis & Clark, Beaver State, Beaverton Banking and Willamette Falls — saw their loans decline. New banks showed increases because of their capital position.

A gloomy picture was reported by most banks. Canby Union said the loan scene was "very bad." Its total on March 31 was more than $2 million below a year ago.

Most banks reported soft demand. Some said the demand is good, but they don't have the funds to lend. All are examining loan requests more closely. A few banks noted some recent improvement. Tualatin Valley, for instance, reported a significant pickup last week.

The deposit results reflect the highly competitive race for consumers' funds. Seasonal factors like tax payments also cause a drain on deposits in the first quarter.

The competitive element finds Treasury bills, money market funds and other high-yielding instruments providing attractive investment alternatives. For example, Columbia Daily Income Co.'s assets increased by $21.8 million in the three-month period.

The high unemployment rate also figures in the results. With fewer persons at work, deposits will naturally be affected. Businesses that have cut back on operations also have less funds to deposit.

DEPOSITS (In Thousands)	3-31-82	3-31-81
U.S. National	$2,102,284	$2,021,158
First Interstate	1,744,581	1,557,240
Oregon Bank	682,569	651,620
First State Bank	426,169	444,888
Oregon Mutual Savings	324,659	334,168
Bank of California	142,384	146,888
Columbia Pacific	48,888	37,918
Forest Grove National	36,561	33,897
Canby Union	33,888	34,918
Clackamas County	32,888	30,428
Lewis & Clark	17,384	8,388
American State	16,788	11,828
Mount Hood Security	9,388	7,888
Metropolitan	9,888	12,488
Independent Bank, Sandy	7,888	7,281
Beaverton Banking	6,188	6,188
Beaver State	6,888	6,888
Tualatin Valley	6,888	6,888
Willamette Falls	6,888	6,188
Metropolitan Bank	3,888	—
Bank of Milwaukie	3,488	3,188
Farmers & Merchants, P. Grove	2,788	1,988
TOTALS	8,988,888	8,871,388

LOANS (In Thousands)	3-31-82	3-31-81
U.S. National	$2,172,888	$2,128,888
First Interstate	2,888,388	2,748,388
Oregon Bank	772,888	674,388
First State Bank	384,488	388,488
Oregon Mutual Savings	338,488	341,888
Bank of California	178,388	178,778
Columbia Pacific	71,388	78,388
Forest Grove National	38,888	38,888
Clackamas County	37,388	37,888
Canby Union	37,888	37,888
Metropolitan Bank	37,888	37,888
Mount Hood Security	37,888	37,888
Beaver State Bank	6,888	7,888
Beaverton Banking	6,888	7,888
Lewis & Clark	6,888	7,888
Independent Bank, Sandy	6,888	7,888
American State	6,888	6,888
Willamette Falls	6,888	6,888
Tualatin Valley	6,888	6,888
Mercantile Bank	3,888	—
Bank of Milwaukie	3,788	3,888
Farmers & Merchants, P. G. Nat.	3,388	3,888
TOTALS	7,388,388	6,888,888

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Portland, Oregon 97230
503/666-4577

SEATTLE OFFICE
3918 148th Avenue, N.E.
Redmond, Washington 98052
206/885-3073 or 206/882-4181

SALT LAKE CITY OFFICE
1800 West 1700 South
Salt Lake City, Utah 84104
801/972-2822

CALIFORNIA OFFICE
25055 Viking Street
Hayward, California 94545
415/783-0101

Western
FOOD EQUIPMENT CO.

MANUFACTURERS' AFFILIATE MA/FSI FOR FOOD SERVICE INDUSTRY

Pat Marr
Comptroller of the Currency
Administrator of National Banks
Washington, D.C. 20219

Dear Pat:

When I was in Washington March 30th through April 2nd I was sorry to miss you but appreciated David Dolliber and Michael Barton being available for us to continue to register our disappointment at the lack of any type of cooperation from your agency to be critical of the attempted liquidation of Western Food Equipment Company by the United States National Bank. It was helpful, however, that Michael Barton would acknowledge that while he had written the letter signed by JoAnn Barefoot that he had not been aware of the December 19, 1978 letter which included the gruesome statement "proposed to put company in liquidation on a voluntary or involuntary basis was approved by senior loan committee". I was told that there had been some further reorganization and was given names of others who I might contact, however, their appointment schedule was full and while I was able to share some of my frustration with Alan Herland at the FDIC office I came away from Washington once again feeling that our concerns were still falling on deaf ears.

I'll be back in Washington May 20th as part of a 12 day business trip combining normal Western Food Equipment Company activities with the opportunity of meeting with potential Stewardship Bank organizers in 6 cities including Atlanta, Boston, Chicago, Miami and the Metropolitan New York City area. I've appreciated the invitation to present testimony for the House Small Business Committee related to the effect of high interest rates on small business. I would hope to have the opportunity of meeting with the highest ranking member available at the Comptroller of the Currency office regarding our continued grievance with U.S. National Bank and our disappointment that as yet your office has not been willing to raise a finger to find any fault with United States National Bank.

We will be supplying copies of this correspondence to some of our Oregon Congressmen and I would certainly appreciate an opportunity of meeting with the highest ranking person available.

For your benefit and that of others whom we are asking to assist let me refer to the overall problems of the small business community as spelled out during the past 25 months by some members of the media.

John Cunniff of the Associated Press quoting Arthur Levitt chairman of the American Stock Exchange stated in the Sunday Oregonian of January 13, 1980 "is fighting for its life too extreme a description of the predicaments of small business? Small business people don't think so. They say they are being crushed by Big Business, Big Government and Big Unions."

More recently Robert Bennett in the New York Times business page of April 25, 1982 referred to "how the Banks are squeezing small business". On March 31st the same New York Times referred to the spreading business failures. That problem stretched over the past two years is exemplified by the enclosures from the Portland Oregonian and Journal referring to the United States National Bank failure to cooperate with Jim Woods at Francis Ford which is now out of business with their 60 employees seeking other jobs or drawing unemployment. There is a possibility that a smaller truly small business oriented bank may be able to put Francis Ford back into business. No thanks to U.S. National Bank!!

U. S. National Bank was more specific in attempting to liquidate Western Food Equipment Company - the company not the loan - as per the enclosed statement of liquidator Ernie McDougal. Western survived. No thanks to U.S. National Bank!!

The gruesome story of the U.S. National Bank attempted liquidation of Western Food Equipment Company is going to be accelerating. Not too many Americans read the enclosed Salem Oregon Statesman Journal article referring to U.S. National Bank's liquidation which would have closed the company. Govenor Atiyeh has side-stepped the concern that Lynn Wallace, Westerns President, presented at the open forum of the Oregon Govenors Conference on Small Business Problems December 15, 1980. A copy of Lynn's remarks are enclosed from which Walt Penk made his report.

A few more readers were involved in the reference in the September 1981 Food Service Equipment Specialist article which includes, "the idea for the bank came to Laughlin in 1977 when his bank tried to liquidate his company. Our company has always been very worthy of credit," he says, "for six years we did business with the big bank that was our excellent friend. Suddenly they made a turnabout and attempted - of all things - to liquidate our company. It was a rather unforgettable experience. We resisted and went to another bank where our credit line went from $300,000 to $500,000 and the interest rate was 1% lower. We had been very trusting of the banking community until they tried to wipe us out without proper cause."

There were probably a greater number of readers of the Kansas City Times article of December 12th where their interpretation read, "Western had a close relationship with the banker they had dealt with through the years, but the banker was transfered through a promotion, leaving Western at the mercy of someone else. Instead of getting the 50% credit line increase it had expected, the firm suddenly had an uncertain future said Mr. Laughlin, Westerns Chief Executive Officer and Chairman of the Board. 'the bank put out a hit to liquidate us, but the corpse came back,' he said". Another bank based on Westerns solid accounts receivable and inventory picked up the financing at a lower interest rate and the credit line went to $500,000."

You can see from the enclosures that John Cunniff on December 9, 1981 had a larger reading audience when his National Associated Press column was printed throughout the country including the portion "and his purpose now is to correct what he sees as an outrageous injustice done to small business. Laughlin's anger can be traced back at least to October 1977 when he maintains, U.S. National Bank arbitrarily attempted to 'liquidate Western - not its loan - but the Western Food Equipment Company.' Laughlin repeatedly sought an explanation of why a long standing relationship should be ended so

abruptly, but, he said he has never received one. He did, however, obtain new financing, at better terms, from Canadian Imperial Bank of Commerce. He survived; he won't forget. He beseeched Federal Banking Authorities to chastize U.S. National Bank, which after investigation they declined to do. He feels he got a run around in his attempt to 'assure Western and other Oregon small businesses that there will not be a repeat performance where a worthy business could be stamped out.' He is considering litigation."

In addition to the National Associated Press article the Sydney Australia Morning Herald picked up the wire story and the Elisabeth Wynhausen interpretation reads, "he became disillusioned about bankers habits when the U.S. National Bank arbitrarily tried to foreclose on his loan, or, as he puts, 'liquidate' the company. He sees the action as characteristic of the way major banks treat small business, and said, of the details of the matter, 'we have the potential for a Watergate type experience here Elisabeth.' He resolved his immediate problem by taking a loan (at a better rate of interest) from the Canadian Imperial Bank of Commerce, but is still waiting to see if his old bank offers him an explanation and apology."

Trade Association writers are picking up on our "experience" as indicated by the "The Wholesaler" distribution voice of the plumbing, heating, air conditioning and refrigeration industry where Marianne Falkman saw fit to use as her lead paragraph "In July 1977 the local branch of the U.S. National Bank abruptly and without explanation decided to terminate its 6 year banking relationship with Western Food Equipment Company, Portland, Oregon. The wholesaler had 30 days to locate a new cooperative bank. But with the companys on-going change to computerized accounting, up to date financial information could not be available on such short notice. Westerns C.E.O., Robert Laughlin, realized that his 29 year old company was facing imminentcloser. The drama ended when Canadian Imperial Bank of Commerce - the 7th largest bank in North America - agreed to issue a greater line of credit at less interest to the Portland Wholesale firm."

The National Association of Wholesale Distributors coverage in the "Channels" of January 1982 discreetly writes "after six years of solid banking relations, Western Food Equipment Company, and NAW individual firm member, was shocked to be told by its bank to find another lending institution within 30 days - that his business was no longer wanted. No written reason was given....we were caught in an abrupt change of personnel and policies at the bank...."

The May issue of Nations Business perhaps would be one of the larger reading audiences and they discreetly referred to "Laughlin first considered forming a bank when in 1977 his Food Equipment Distribution Company had trouble obtaining favorable loan rates and a continuing credit line at a local bank." As in the case of most of the other media articles we receive numerous inquiries as to "how did it all get started?" Our policy is to "tell the truth and send them proof".

As Western Food Equipment Company continues to grow and create new jobs it becomes almost ridiculous almost five years later that the Federal Regulatory Agencies would conclude that "U.S. National Bank had the right to liquidate Western". I thought that "attempted murder" was a crime in some states. Just for the record Westerns gross revenues for the year ended January 31, 1982 increased 24.2% for a new record maintaining the steady up-ward trend of the past 12 years.

Did Western Food Equipment deserve to die based on the distant decision of a senior loan committee, none of whom ever have met the Western management or visited the premises?

It would seem to be increasingly difficult to attempt to raise the image of National Banks. Let me refer to some of the activity in the area of the "phony prostituted posted prime fib". You are familiar with the Wall Street Journal article enclosed where Jackie Kleiner states, "the banks artificially created the prime to make higher profits and then artificially discounted it. They are white collar criminals in three piece suits." You should be familiar with the House Banking Committee Staff report where chairman St. Germain of Rhode Island "suggested that the industry abandon is painfully drawn qualifications about the prime rate and adopt in its place a "lowest" interest rate for business borrowers with all other rates scaled up-ward from that rate. He closed with, "should voluntary and supervisory efforts fail to create a rational, fair and understandable pricing system that means what it says, the Congress should consider action to protect the publics right to have access to accurate data about this vital sector of the American Market Place."

The 101 page "analysis of prime rate lending practices at the 10 largest United States Banks" includes on page 4 under the sub-section "discounts from the prime" the following statements: "The Federal Reserve conducts quarterly surveys of bank lending practices. The survey includes data on 20,000 loans at 340 commercial banks. These studies reveal a sharp increase in below prime rate lending activity beginning in 1980. The Federal Reserve data shows, for example, that the large banks in New York City made more than 60% of their business loans below the publicly announced prime in four of the last five quarters. The first quarter of this year shows that the figure has exceeded 70%."

The Time Magazine writing May 18th stated "the committee found that during May 1980 more than 80% of the commercial loans granted by large New York Banks were made at rates below the prime, then 17%. The average rate charged: less than 13%. Chairman St. Germain maintains that the posted prime rate has now become an excuse for banks to jack up interest rates." I am quoted and Jackie Kleiner also.

I should certainly clarify that I am writing to you as the Chief Executive Officer of Western Food Equipment Company whose organization was the target of the hit from U.S. National Bank. While we have been one of the organizers of the uniquely honest Stewardship Bank of Oregon we do not presume to have this complaint considered by any other organization except Western Food Equipment Company.

The media attention to Stewardship Bank of Oregon has been almost unbelievable and continues to increase with most of the stories dwelling on the positive. Related to the prime rate farce , however, the Los Angeles Times, October 24, 1981 with an article beginning on their front page stated "it was decided to form a 'Christian bank' and share the profits with Christian schools. There is alot of dishonesty and greed among some members of the banking business, Laughlin said. There are banks that lend money 4% and 5% below announced prime rates to favored customers. Small businesses are often given the short shrift, with favortism shown to the large corporations." Charles Hillinger's article was printed in numerous papers across the country with the Huntsville, Alabama article enclosed repeating the statement without the "alot of dishonest banks" byline while the Minneapolis Star and Medesto Bee saw fit to remove it all together.

John Cumniff of the Associated Press in his National AP wire story December 9th did an excellent job of covering the 3 beautiful and 3 gruesome stories involved at Western Food Equipment Company and it is my understanding that he may be elaborating and expanding on some of the issues. Yes, I would not want the task of trying to elevate the image of National Banks when an increasing number of Americans swallow hard when they are told that the "prime rate is such and such" and they increasingly are aware that "the prime is not the best". When will we have the truth?

I believe we should point out as you should know the banks are not winning in the courts. The Australia article saw fit to use the headline "U.S. Bank loses court action over charging high interest rates." They were referring to the United Kentucky Bank and the decision as reported in the Courier-Journal June 28th "verdict slashing interest on loan may be a first" and where the Wall Street Journal on July 7th elaborated on whether a legal precedent may or may not have been set. You should check out for your own satisfaction that this litigation has now been settled with forgivness of loans and/or cash paid totaling over $1,000,000. You may want to check out the details of "Kenneth & Alberta George vs. United Kentucky Bank - civil action file #C-82-002-L U.S. District Court for the Western District of Kentucky." I know of at least 15 litigations now on file regarding the "phony prime". Two are in Portland as reviewed by the enclosed Willamette Week article.

Check out the settlement please with "Provident Credit Corporation vs. First Pennsylvania Bank - civil action file #CA-82-0311."

We will continue to ask for the truth regarding the "prime rate" and for a smaller differential between the interest extracted from small businesses and those concessions given to larger business.

Banks lose in court in Portland also as covered in the January 23, 1981 article "Jury orders bank to pay $558,000." I've left at your office a copy of the suit against U.S. National Bank by James and Betty West and I'll hope to become current on the status of that action which resembles some of the format that Western might also file.

I must say that most of what we have spelled out to this point is "bad news".

In the "good news" category we can refer to the "a new kind of bank" article from the Oregon Business of March 1981 which again shares the overall story without naming U.S. National. The U.S. Chamber of Commerce in April 1981 shared the good news of "small business group starts its own bank" and refers to a written small business philosophy and "cooperation with qualified small businesses on a preferential basis to supply loans at a prime rate or less." The farce of the "phony prostituted posted prime fib" made it relatively easy for Stewardship Bank of Oregon to properly price its loans based on cost of funds from selected deposits and carry out that statement at least from March through September of 1981.

Is it any wonder that Stewardship Bank of Oregon is showing the deposit growth in the Tri-County area that passes the gains or loses of deposits of 17 of the other 21 banks reporting March 31, 1982. As the Kansas City Times headline reads "financial institute banks on principles of Christianity".

The syndicated column of Mark Watson of the New Jersey Courier Post printed in 18 newspapers with a reading audience of 5,000,000 has used the phrase "small business bank goes one better than prime rate." The "good news" continues to be spread through publications such as the May 1982 Nations Business or the February 1982 Christianity Today article "the country's first Christian bank".

Not only do we project that the Stewardship Bank of Oregon deposits will continue to grow because of the innovative concepts but it is also noteworthy that I have now met with some 35 different potential Stewardship Bank organizing groups from every corner of this country from Anchorage to Honolulu to Miami to Boston to Seattle and points in between. Yes, I believe that there will be 100 Stewardship Banks operating 5 years from now because we are meeting specific needs in our communities.

I cannot accept the interpretation that United States National Bank is incapable of making a mistake and that Western Food Equipment Company was not deserving to live and that the U.S. National Bank has the right to liquidate our company. It just does not fit the facts!!

It is ridiculous that in the eyes of an increasing audience that the Comptroller of the Currency would refuse to make any type of private or public reprimand of U.S. National Bank. Please be assured that many are continuing to watch!! We will continue to speak the truth and send proof as we are asked how the unique Stewardship Bank of Oregon happened to be inspired.

What would we like?

1. The highest level meeting possible the afternoon of Thursday, May 20th.

What do we want from U.S. National Bank?

1. We want to meet with U.S. Bank president Bob Mitchell, our "former friendly banker John Eskildsen" and review the impact of the U.S. District Court Jury decision of December 19, 1979 that U.S. National Bank had made a vicious attempt to liquidate Western Food Equipment Company. That verdict was accepted by the Magistrate as per the enclosure.

2. We want an apology from U.S. National Bank for their inappropriate attempt to liquidate our company.

3. We want proof of their sincerity.

Most importantly as we move through National Small Business Week we would like some assurance that U.S. National Bank will not continue with the arbitrary attempted murder of worthy small businesses like Western or examples of the failure to meet the broad need of the community as exemplified by their decision to let Francis Ford Company die.

We have repeatedly asked Bob Mitchell to meet with me and for more than two years he has refused to do so with the general encouragement that "we should see our lawyer."

We would like to see the National Bank administrators support Westerns concern on all four points. At the moment we would settle for having you encourage Bob Mitchell to meet with me and Lynn Wallace, Western President, and sincerely review their responsibility of having made a gross mistake.

We feel that this American Small Business is entitled to some of your support!!

If litigation is our only last resort then we will explore it to the fullest within the time frame of the statute of limitation governing the circumstances. Western has never sued anyone in 34 years but it seems as though in the prime rate issues that larger banks ignore smaller people until they are taken to court. Unfortunate!!

In this case we have already been to court and have won!!

I know enough about the human element in the Stewardship Bank of Oregon to know that we can make a mistake and I know that we are able to admit it. U.S. Bank has admitted one mistake in another matter where we "caught them with their hand in the cookie jar" and I would like to see them admit that they have made another.

We will continue to keep the media informed as they express interest in our concerns for truth and justice.

We trust the eventual bottom line will read something like this, "after almost five years of on-going success of Western Food Equipment Company the United States National Bank finally was willing to admit that they made a mistake in attempting to liquidate the company and has apologized to Western for the attempted liquidation.

We would like to be able to show that indeed the Federal Regulatory groups do have some willingness to finally listen to the complaints of a tenacious small business and to influence some action.

If we continue to get the same evasiveness of the past 27 months then we will continue to go to our congressmen and the media asking for their review of the sorry conduct that would allow "legalized liquidation" of a worthy small business without government intervention.

The first steps in respect to our concerns would be an appropriate meeting with the highest ranking authority possible from your agency, preferably the early afternoon of May 20th. I'll hope to call ahead May 19th from Miami where I will have been meeting with potential organizers of the Stewardship Bank of Florida.

Your concern and cooperation please with this small business?

With continued strong conviction,

Robert E. Laughlin
Chief Executive Officer

REL/eir

CC Michael Barton
C.T. Conover
David Doliber
Senator Mark Hatfield
Alan Herland - FDIC
James McAfee - Federal Reserve, Washington D.C.
Senator Bob Packwood
Frank Swain - Chief Counsel for Advocacy U.S. Small Business Administration
Congressman Ron Wyden

Tues., March 9, 1982, Denver, Colo. Rocky Mountain News

Opening a new bank easier than expected

By LYNDE McCORMICK
News Staff

Want to open a bank? A degree of mystery exists about the process of starting one, but it's not as hard as people might imagine. It's also an especially popular pastime in the Denver business community. In a high-rolling economy such as Colorado's, a new bank can turn a tidy profit in a short period of time.

Banks are usually started by two or more people — the bigger the bank, the bigger the group — who decide that a community can support another commercial bank. These organizers put together the necessary capitalization and then troop on down to the local clothiers for fresh pin stripe and gray flannel outfits. (Some things never change.)

Although commercial banks require a sizable chunk of money — capitalization often starts at $1 million — to get under way, Colorado commissioner of banking Richard Doby notes that the capitalization is often borrowed funds. Big banks, in return for a correspondent relationship, loan up to 100 percent of the money needed to buy an existing bank and up to 75 percent of the money for new banks. The rest comes from the organizers' deep pockets or the sale of stock.

A pin-stripe hopeful has two ways to go to open a commercial bank, three ways if an industrial bank is a possibility. Industrial banks are generally easier to open than commercial banks, requiring substantially less capitalization, and they are the toehold that a number of out-of-state banks have taken in the Colorado economy. But they bump into some tough restrictions regarding the types of business they can do. Commercial loans, the gravy for most new banks, are not the main fare of an industrial bank. Less-profitable consumer loans are.

Which leaves the other two paths. Bank organizers can turn to Uncle Sam for a national bank charter, or they can turn to state bank commissioner Doby for a state charter. To Doby's disappointment, most of the new banking activity bypasses him. The state banking division has, in the past, tied charter applications up with a slow-moving tangle of red tape and delays. It was not uncommon for two years to separate the filing date of a charter application and the final approval. So bank organizers took their business elsewhere, a few miles away to the U.S. government.

Richard Doby
Cutting Colorado red tape

The U.S. comptroller of the currency makes life easier by a long shot when it comes to granting a national bank charter; no automatic hearings, a thin layer of bureaucracy to wade through and a six- to eight-month waiting peri-

(Continued on page 8B)

Starting a bank not hard

(Continued from page 7B)

od. A U.S. comptroller in the early 1960s aspired to bring national branch banking to the country and vowed to plant nationally chartered banks on every street corner as a prerequisite. What he brought was an anomaly to the federal government, a streamlined bureaucracy. As a result, bankers here have found little reason to plead their cases before the Colorado banking commission, and most of them haven't.

Compared to the seven commercial banks chartered by Colorado in 1981, the U.S. comptroller's office approved charters for 29 banks.

Doby wants to change that situation and has taken some steps in that direction. "We had seen a dwindling of state-chartered bank requests because of inordinate amount of time between the request for a charter and the hearing date," he says. So he shortened it. Doby's office now sets a hearing date within 15 days of receipt of the charter application. It used to take months. He has also narrowed the duration of the hearing from as much as two days to 2.5 hours. After the hearing, the commission, which Doby chairs, meets informally in Doby's office and takes a vote on the application. The result is forwarded to the organizers that day, pending a more formal vote at the next monthly commissioners' meeting.

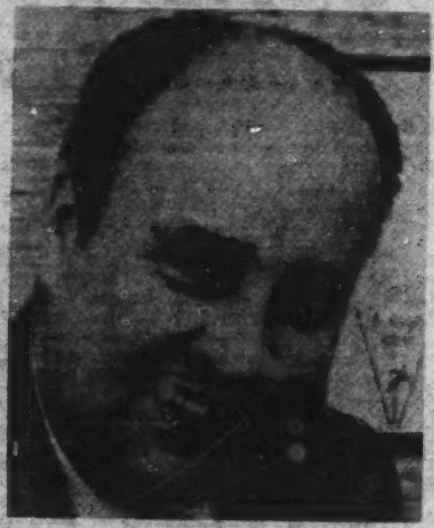
If the first two months of 1982 offer any example, Doby's new policies have had some impact. His office has looked at five state charter applications so far this year compared to one over at the comptroller's office.

Even so, a national charter holds some distinct advantages. Part of the reason for the state banking commission hearings is to allow protestants to the new bank to speak their piece. These protestants are usually competitors, financial institutions already plying their trade in the new bank's proposed territory. The U.S. comptroller's office, by contrast, avoids any competitive squabbling by avoiding hearings altogether. Letters of protest are taken, but review of the application is an internal affair.

Even if Doby and company approve a bank's charter, which they do 80 percent of time, the protestants can tie up the new bank charter in litigation for months. "For a few dollars, you can go to court and keep a competitor out of your market," says Theodore Browne, managing partner of the economic research firm Browne, Bortz & Coddington in Cherry Hills.

The hopeful state bankers also have to field still another bureaucratic process and be accepted by the Federal Deposit Insurance Corp., which insures depositors' accounts, whereas the comptroller packages FDIC membership up with national charter approval.

"It's hard to advise a bank to go with a state charter," comments Browne, "although the state process has improved. The only time I would recommend a state charter is where capitalization is important." A state charter requires smaller capitalization, generally around $1 million, compared to $1.5 million for a national charter, says Doby.



Theodore Browne
Hard to advise state charter

Customers also seem to regard national banks as somehow more secure than state-chartered banks, says one banker, although the notion is an illusion. "They seem to think of national banks as being like the post office, part of the federal government. A lot of them also think that national banks are the only ones that can make wire fund transfers, which isn't true."

There are some other advantages to a state charter, though, notes George Rock, senior vice president of the state-chartered Bank of Denver. State banks face the same reserve requirements as national banks, but they have to keep less of the reserve in cash. "We can invest some of that reserve in any free government bonds," says Rock, "so a state bank can earn some income on reserves that just sit in a national bank."

A state charter application requires the organizers to hire a feasability study on the new bank, and most applicants for a national charter take the same route. The study, conducted by one of a handful of firms such a Browne's, covers any element in the community that might effect the new bank; average income, employment, local businesses, the competition and a projection of deposit growth.

-Rocky Mountain News Tues., March 9, 1982, Denver, Colo.

Taking risks is how small bank grows

By LYNDE McCORMICK
News Staff

Back in 1977, Michael Bellamy thought he saw the flickerings of a real estate market ready to ignite, and he wanted a piece of it.

To Bellamy, the corridor stretching eastward out of downtown Denver, between Colfax and 20th avenues, looked like an escape valve for the downtown building pressure.

The skyscrapers were not going up as fast as the demand for office space, and neither seemed to keep pace with the rents. Because zoning in that eastern corridor allows for houses to be converted to offices, Bellamy was certain it would be a short time before the Denver building boom would flow in that direction, bringing a demand for relatively low-rent offices but skyrocketing land values.

He was right, but he needed the help of a banker or two to get him started in the real estate renovation business. None of them, however, shared his foresight to the point of lending him money to buy and convert four small houses on Emerson Street to offices. The area was run down, considered high risk.

"No bank was going to touch me," said Bellamy. "They thought I was nuts."

So he bought the five houses and started renovating one in 1978, with private financing. He finished it and again looked for bank financing.

The big banks on 17th Street wouldn't give the matter a thought, but he found a willing ear at United Bank of Skyline in Denver, a bank he heard was among the most aggressive in town. He was right. The bank loaned him $65,000 to start work on two other houses.

"They were taking a risk on me, and they knew it. They were more aggressive than any of the others I talked to, but I think the smaller, newer banks that want to grow have to take risks and be aggressive. I knew the big banks would even consider it."

For Bellamy and Skyline, the risk has paid off. Bellamy has become a steady and reliable customer, and Skyline has become an eager lender for Bellamy.

And his vision turned out to be right. That eastern corridor is one of the few residential real estate markets in Denver where houses move on and off the market in the same week.

Land values, in many cases, doubled during 1981, and Bellamy was in a position to take advantage. His property ownership in the area has grown from the five small houses on Emerson Street to 16 different buildings and houses scattered over the area, all converted or being converted to office space with the prospect of turning rents that previously were unimaginable.

After his first loan with United Bank of Skyline, he set up a mortgage loan on the five houses with East National Bank of Denver, an old-line bank that came under high-spirited new management about 18 months ago.

The loan came to $175,000, $5,000 shy of the bank's then legal limit for loans to any one customer. "That was a pretty gutsy move," said Bellamy, "to lend so close to the limit on the first loan. . . .

"I think East National liked the area. They knew they were taking a risk, but they wanted to take that role. I think they had felt the market out and then singled a few people out who they thought were the best risks."

"Mike is the sort of person we like to work with," said an East National officer. "We had a secondary source of payment, some real estate, and he had some good ideas. They weren't the sort of ideas that look attractive to a larger bank because they don't really have to be too innovative in who they loan money to. They have plenty demand for their money as it is.

"But Mike is just exactly the kind of loan we want to make. He's got good ideas; he knows what he's doing, and he's a good risk."

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Small banks growing like weeds

By LYNNE McCORMICK
News Staff

They provide easy downtown parking with an air of royalty. Arranged behind their shimmering glass towers and round Greek columns, the big Denver banks are the crucible of the area's growth and many think people think the banking industry should be.

They are not, however, everything that banking in Denver is. Small banks, with an eye to a capital base from United Bank of Denver today, spend no annual millions, have spruced and prospered all over the Denver metropolitan area.

Despite their size, many small banks are well-entrenched on the ball track and often more profitable than their larger brethren.

Colorado, in general, and Denver, in particular, have generated a thriving atmosphere where small banks can start and grow profitable. It is one of the fastest-growing markets in the country, said Theodore Browne, managing partner of Browne, Borie & Cuthbertson, an economic research firm in Cherry Creek.

Small commercial banks feed that, breed and better making loans in small business, and despite the heavy and inflicted on the latter's market by high interest rates and a contemporary economy, improvements are still making to make the plunge. "They need loans; they need bankers, and they often find that small banks fill their needs more precisely than the big guys on 17th Street. So banks with as little as $1 million in capital are growing like dandelions in springtime.

The big banks don't necessarily ignore the burgeoning small-business community, but their size and multimillion-dollar lending abilities incline them toward big loans for relatively low-risk companies.

By contrast, a bank such as First National Bank of Denver on East Colfax Avenue has a lending limit of $400,000 on assets of 38 million. With 70 percent of its loan portfolio going to businesses, the bank has tripled its loan portfolio in the past 18 months.

United Bank of Skyline downtown is another example. In the past year, Skyline has increased its loan portfolio by 45 percent, up to 143 million on assets of 188 million.

The bulk of Skyline's loans fall in the $50,000-to-$500,000 range. Between January 1981 and January 1982, the bank posted a 45 percent increase in dollars loaned. "We're looking for small- and medium-sized businesses to make loans to," said Skyline President Theodore Weinberger.

The key is marketing, and bankers are overlooking more aggressively now than those who fashionable would have dreamed possible. "It's a matter of going out and working on doors," said the chairman of one Denver-area bank.

"There are lots of little people out there who would never think of coming into your bank," said George Rock, senior vice president of the Bank of Denver, downtown. "So you have to go out and get them."

Many times, chairmen and presidents of small National Bank, said finding those customers is not necessarily a matter of calling richer loans than the big banks and their Fortune 500 clients.

"When one of those big companies gets

Related stories on pages 7, 10

they really go. There's no real estate to liquidate. When we make a loan, we make sure the customer has a primary source of repayment and a secondary source, like some real estate, in if something happens. We have a way to measure our success — delinquency, a customer will be very reluctant to put up his home, but then we ask, 'You mean you don't intend to repay the loan?' and they see the logic of it."

"Most of what we have to offer is service," said one bank president. "Our response can be small quicker. I can call a loan committee meeting any time ... and three of the bank's five directors could be at the bank, so if we need to, we can get a loan approved on the same day.

"With correspondent relationship, a small bank can do everything a large bank can do, but it can offer better service. We have the opportunity to be more creative with a customer, more understanding of his situation."

What they can't do is compete on profit margin. One banker, who asked not to be named, reported a profit of about 1.7 percent return on assets, compared with a statewide average of 1.25 percent and a "rule of thumb" profit margin of 1 percent or less for larger banks. (Small banks, with fewer number investors, usually are more efficient than large banks.)

Banks have profits in a number of ways, most of them tangled up in the differences between the interest they pay for money and the higher interest they need to earn. Virtually all of them have a mix of consumer-installment loans, such as auto loans, and commercial loans.

(Continued on page 10)

Omni Corp. being liquidated

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Prime rate dips to 16 percent

PAGE 2B

-Rocky Mountain News Tues., March 9, 1982, Denver, Colo.

Bankers change image

(Continued from page 1B)

The banks that have punched into overdrive, despite the recession/inflation/high-flying-interest-rate environment, have concentrated on commercial loans. They float above the prime rate, usually by two or three points, and guarantee a return regardless of the volatility of national money markets.

At one small Denver bank, for example, 70 percent of the loan portfolio travels with the prime rate, which is 16.5-percent. The other 30 percent are a combination of consumer loans and long-term real estate loans left over from the previous management. Most banks shun fixed-rate, long-term loans as a matter of policy.

When interest rates climb to ridiculous levels, as they did last year with a 21 percent prime, a bank can turn a cozy, no-risk profit by socking its money into federal securities.

In 1981, they paid as much as 22 percent. "It was really tough for a bank not to earn money last year if for nothing else than for the Fed fund rates," said one banker.

Along with the bustling demand for new banking has come a new breed of bankers. Somewhere in the public mind lurks an image of bankers as stuffed shirts stuffed into pinstriped suits: conservative men who arch their gray eyebrows, shake their forefingers and say "a penny saved is a penny earned."

Not in Denver. Bank officers in their early 30s are increasingly common, as is the potential for them to carry home fat paychecks. "I have one bank that I call 'boystown,'" said Browne of Browne, Bortz & Coddington, the economic research firm that, among other activities, prepares feasibility studies for new banking ventures.

"There's not a gray hair in the bunch." Browne declined to name the bank, but said it belongs to one of the most successful banking groups in the area, and he attributed much of that success to the young age of its management.

The chairman of the bank brings his staff in early and encourages rapid climbs up the ladders — and expanding assets for the bank — with lucrative incentives.

Mr. NOWAK. Thank you very much, Mr. Laughlin. We have all of the attachments and they will be made part of the record, including the press reports of what has happened to your small business in Oregon.

Over the last year, we have tried to look at some ways that we can externally and internally generate capital for small business, and have discovered many of the things you have found in your own experience to be widespread. Where there is a difference in the prime rate, the banks argue there is a greater risk factor for small businesses and use that as a justification for certain differences in the rate. I don't know where we can do much about that, but, certainly, as we start to look at deregulation, there have been many small business organizations throughout the country who have requested that we hold these hearings to give us the opportunity to look at this from the unique point of view of the small business owner.

Last year we went before the Tax Committee and submitted on behalf of small business a statement, in which I was joined by Mr. Marriott. The subcommittee did have some input and although all of our recommendations were not adopted, we did, I think, have more impact on so-called tax incentives last year than we would have if nobody had appeared as has happened for the last 40 years.

This small business emphasis, I think, is finally coming into vogue where people are starting to realize the impact that small business can have on a community, especially in today's world. Small business in general has a strong effect on diversification in a community where you have had high unemployment, because you were relying on one or two large industries. Now, these manufacturing plants may have left the area, or the country, and you are left with trying to readjust not only the mix of businesses, but having to retrain people for new jobs. These are problems which have to be faced when trying to stimulate small business innovators to make up for the unemployment problem. So, it is a whole mix of problems.

I wonder if you have come to any conclusions why the interest rates have remained so high so long?

Mr. LAUGHLIN. Well, Mr. Chairman, the reference to the prime rate really being a farce, I have written to President Reagan last September requesting that we simply use the accurate information in the media and through the banking circles and do what Congressman St Germain had asked, that we begin to refer again to the prime rate as the best rate in a fairly worthy corporate customer. It is my hope that we simply would psychologically move away from the term "prime" and that we would acknowledge that the best rate to the larger corporations is closer to 12 percent than 17. I think that without changing any of the numbers, we would psychologically have people thinking upon more positive information.

So, to me, the prime rate just simply being done away with, I think we can psychologically really improve things if we can simply go to the truth in prime, which was the spirit, I think, of the staff committee report last year.

To me, even to those who are not borrowing, recession is certainly related to some psychological factors, as well as the reality of what the interest rates are. But I think from the standpoint of

the smaller business person, if he knows that the average rate is 16½ or 17, then he is in a position of bargaining with his source of funds, I am speaking for the smaller business aspect, you see. I would hope that at that point that they would be able to negotiate and we certainly have many examples where they have negotiated for a lower interest rate.

Some of the groups that are forming banks across the country, a group in New Jersey, when they became aware of some of the facts of life, because 90 percent of the American small business persons are still assuming that the prime rate is the best rate. And until that is changed, they are going to be paying points over what they think is the best rate and they are absolutely misled.

So, if we can have truth in prime, then I think we will have an eventual reduction of interest cost for the small business.

Mr. NOWAK. I think we understand your basic premise in talking about who fixes the prime and where the prime fix has been. I am trying to get at the basic reason for the differentials here between the 6-, 7-, and 8-percent rates that were prevalent in the fifties, sixties, and early seventies, and the change that has occurred now within the structure to move that rate.

We are told by the banks, large and small, that their cost of money has gone up so much and we are trying to figure out why that cost of money has gone up so much. You can make a blanket statement that the Federal Government has borrowed extensively over the last couple of years and because of the tremendous increase in that borrowing, that sets in motion a cycle for the cost of money to the banks. We have developed a change in the structure now where in the last couple of years we have allowed new financial institutions to blossom and we have tried to look at the impacts of what the money market funds have done to the banking institutions and what kind of competition that has set in place. From that you sort of realize that that is where the cost of money is now coming from.

When you look at the tremendous growth in those money market funds and now in the future it will be Sears with their supermarket financial services, the whole structure has changed so much. We have probably had more changes in the banking community in the last 1½ years than we have had in the previous 30 years. We are sort of stuck with trying to realize how the rate could come back down and what can we do to pull it back down.

I just feel that we have a greater difference in today's so-called financial community than we have ever had and we still don't realize the impacts of the changing money market funds and the changes needed to bring the banks to be competitive again so they can borrow money and, hopefully, lend money at more reasonable rates.

As we talk about widening the opportunities for banks and talk about the Glass-Steagall Act or the McFadden Act, that is probably all going to lead into more competition. Whether a small bank can survive is the real concern of the banking community who testified yesterday about the smaller independent banks. They are just fearful that they are going to be eaten up as all of this happens.

But the structure in putting the smaller banks in competition with Merrill Lynch and yet not giving them the tools to work with

probably places them in a worse position than a larger bank because they have fewer tools, fewer adjustments that they can make.

Does your association have any feeling as to the impacts of those new big mutual funds and the so-called supermarket of financial services that are coming into being?

Mr. LAUGHLIN. I might leave that area for John Fitch, who is a real specialist with NAWD to speak to, Mr. Chairman. If I can use the position from which I come from as the start of the new Stewardship Bank, we opened in April 1981.

According to the Comptroller of the Currency call at the end of March, there were 22 banks in the Portland area reporting a deposit growth. Eight of those banks lost deposits during that year. Stewardship Bank from a standing start had 1,400 accounts and $4 million in deposits during the time that that loss was going on there. Nine other banks had gained less than $4 million.

A small business oriented bank with other unique profit-sharing concepts, they were completely innovative in two different ways. We find that we are building deposits in the face of that. There are only four banks that gained more deposits in the tricounty area than we did in the past year and three of them are the largest banks in the State. We found that we could attract deposits. We believe in the free-enterprise system. If the money market people are able—at this point I am speaking for myself—without reserves and without insurance to attract some of those deposits, in a sense, that is part of the free-enterprise system.

We found in the competitive marketplace that our bank, being innovative, was able to attract deposits. I feel that you will see a series of people responding with their deposits to banks that are coming forth.

May I say, as far as the high interest costs in general, I am assuming that others have spoken to the fact that is so basic that the Federal deficits of so many years certainly have created the competition in the source of funds. I would certainly pray literally that there will be a balanced budget, and there are meetings going on right now, and certainly those things are basic and I didn't address them, assuming that others have spoken to them. Those things are understood.

As you may know, at the White House Conference on Small Business, one of the top 15 priorities has been that there be a balanced Federal budget. I am just assuming that that has been addressed. But small business owned banks, operating on their own innovatively have been attracting deposits and as a result then making loans on a fair basis.

You can see in the report there that literally from March until September 1981 when the phony prime was up at 18 and 20 percent, every business loan we made was being made below the publicly announced prime.

Now, our source of our funds are not the Fed window or the Federal Reserve or whatever. Our source of our funds are deposits and when thinking Americans deposit their funds into a free-enterprise bank system that is committed with written philosophies as you see in front of you to support the small business people, they respond. So, we are trying to speak to the possible alternative as well

as some of the horrible problems. We never would have investigated if we hadn't gone through the big banks.

Mr. NOWAK. Well, certainly, you have had a horrendous experience in Oregon. I don't know how extensive you can generalize that statement over the country. There have been on occasion large institutions which have been able to provide that kind of community service to the small business community. However, I think they have to be sensitive to it and they have to have people in the banks that realize the impact not only on their own success, but on the success of the whole community by providing the kinds of seed dollars that make that tremendous difference.

Mr. Marriott.

Mr. MARRIOTT. Mr. Laughlin, what was your basic problem with Western in Oregon that you have been alluding to in terms of your relationship with the banks?

Mr. LAUGHLIN. OK. They had solicited our account in 1971. We had a beautiful relationship for 6 years. As big banks have a pattern, there was a change of management. All of a sudden we were dealing with a stranger and with an ivory tower. So, those people who did not know us saw fit to, for various reasons which are still being reviewed—saw fit to ask us within 30 days to find another bank and they knew that we were in the midst of an in-house computer installation. The heart of our problem was their request, after 6 years of being wanted, they asked us to go find another bank within 30 days. It took us about 8 months to make that change, at which time we went to a $500,000 credit line instead of $300,000 and the interest rate was 1 point less with the Canadian Imperial Bank of Commerce.

We went to a bigger bank who carried on the attitude that we had always had from the branch of the United States National Bank. So, the problem is smaller business people changing personnel on the part of larger banks would be the general problem that we were caught up with. Also, there were some circumstances that were very, very unique. That is why we refer to the Watergate example.

Mr. MARRIOTT. You have a bank now that you have an interest in that makes loans primarily to small business. What interest rate are you charging your prime customers?

Mr. LAUGHLIN. OK. I should clarify now. I am one of the organizers of the bank, but I am not a banker. Again, our cost, and I go back to when we got underway when the prime rate was high—our cost of funds has probably continued upward. I am making a guess at this point because that is the province of our bank president to set that and it does not change with the prime rate change.

I would say that today our interest rate is probably in the area of 17 percent. However, I can assure you this. There is no one borrowing at 6 points below that and that is referred to as our best rate and the bulk of our loans are made at the best rate. Western Food Equipment is still with Canadian Imperial Bank of Commerce, 2 points over prime until our bank, Stewardship Bank, can go to the point they can handle ours. Our credit line is now $750,000.

Mr. MARRIOTT. Your best rate at Stewardship Bank is 17. You are now borrowing money from the Canadian bank at——

Mr. LAUGHLIN. Two points over prime.

Mr. MARRIOTT. So, that would be 18½?

Mr. LAUGHLIN. Right. And the bulk of the loans that I would expect Dick Wells, our president, to make would be made at our best rate or, perhaps, 1 point over the best rate. So, we are still very competitive in that market.

Mr. MARRIOTT. Just one last question. If you were to go down to a bigger bank and try to borrow money today, what would you be borrowing at?

Mr. LAUGHLIN. Western Food Equipment?

Mr. MARRIOTT. Yes.

Mr. LAUGHLIN. We, at the larger bank, at Canadian Imperial, are 2 points over prime on making use of the full amount of our credit line.

Mr. MARRIOTT. Two points over prime is no deal, is it?

Mr. LAUGHLIN. It is a bad deal. I do not know, and let's say that I have almost been reluctant to ask the Canadian Imperial Bank of Commerce as to their program of dealing with larger corporations. I feel that they are not as guilty of loan discounts from the prime rate as we know—there are two litigation actions against First Interstate and First State Bank in Oregon, but there is no litigation against Canadian Imperial Bank. I think that they have played it down the middle. They have been truly committed to the small business community where, Mr. Chairman, I think that as far as motivation, the area of greed has been with us for many centuries and when larger banks have more of a concern on the part of their owners and the management team to maximize their income, as compared to taking care of the needs of the small business person, that is when the problem comes up.

I think Canadian Imperial Bank, even though they are 10 times larger than United States National, is sincerely committed to helping the small business person.

Mr. MARRIOTT. What was your financial situation when the first bank asked you to find another bank?

Mr. LAUGHLIN. When we took our financial statement to Jim Butler at Canadian Imperial, he looked at it and said he saw no reason why we should not have an increase in the credit line that the branch of United States National had been recommending. They had recommended that we go to $450,000. When we had our financial statement up to date, Canadian Imperial followed through with the commitment at the $500,000 level at 1 point less. Our financial statement was such that we were entitled to credit on the interpretation of a larger bank.

The action of United States National, believe me, is very, very suspect and this is why we have been with the Comptroller of the Currency.

Mr. MARRIOTT. Thank you very much, Mr. Chairman.

Mr. NOWAK. Thank you, again, Mr. Laughlin, as you have in the past, to bring this to the attention of the committee. Your complete statement will be available for not only all of the other members of this subcommittee, but we will have a report that, hopefully, will get to all the banking members as well. Thank you.

Mr. LAUGHLIN. Thank you.

Mr. NOWAK. Our next witnesses are the National Small Business Association and I understand we have a change in the person who

will give the testimony. Mitchell Kobelinski was supposed to testify, but I understand he missed the plane in Chicago and Jerry Gulan is here, who is the vice president of NSBA. It is unfortunate that the former SBA head missed the plane, but a good friend of our colleague from Chicago, John Fary, would like to make a short statement.

Mr. FARY. Thank you very much, Mr. Chairman.

Mr. Kobelinski, who is vice chairman of the Parkway Bank & Trust Co. unfortunately will not be able to attend today's hearing. His bank in Harwood Heights has been active in providing loans to small businesses.

I am very pleased to see that Chairman Nowak invited Mr. Kobelinski to appear before us today. Mitch has been active in the Chicago area in terms of community affairs and business investment. For 10 years he made his livelihood as a general contractor in the area.

Though he will not be able to be with us today, he would have made an excellent witness. He has had extensive experience in small business. He was formerly Administrator of the Small Business Administration during the Ford administration. In his place I welcome Jerry Gulan, vice president of NSBA. I might add that the name Kobelinski is a household name in Chicago and is extremely well respected and a great name with the Polish National Alliance and the local organizations and I can say that without any fear of any contradiction, as an American of Polish descent.

Thank you very much. It is nice to have you here.

Mr. NOWAK. Thank you very much. We have Mr. Gulan, who has appeared before the committee before, we will put Mr. Kobelinski's statement in the record, and you may proceed.

[Mr. Kobelinski's prepared statement follows:]

Prepared Statement of Mitchell P. Kobelinski, on Behalf of the National Small Business Association

Mr. Chairman and distinguished members of the Committee, my name is Mitchell Kobelinski. I am appearing here today on behalf of the National Small Business Association (NSB), a multi-industry trade association representing approximately 50,000 small business firms nationwide. I am a member of the Board of Trustees of NSB. Through the years I have worn a number of "hats". I am an attorney by profession, but for 10 years I made my livelihood as a general contractor in the Chicago area. I have spent more than 25 years of my life in the community banking business and am presently Vice-Chairman of the Board of the Parkway Bank & Trust Company in Harwood Heights, Illinois. In addition, I spent almost four years as a Presidential appointee in Washington including time as Administrator of the Small Business Administration. The matters I would like to bring to your attention today are considered from the several points of view that my past experience provides me -- small businessman, banker, and public official.

The almost desperate need for capital which small business has always experienced has been aggravated in the past several years by both the reduced availability and the extremely high cost of borrowed money. The macro-economic conditions which have lead to this unhappy state of affairs are already well-known to you, and I will not belabor that subject. However, some very specific phenomena have occurred which have aggravated the problem of availability of monies for small business in a bad way. This Committee knows the important role that small business plays in the American economy, its great contribution to the GNP, and the fact that it has been the single greatest source of employment and new jobs for decades.

To establish or expand a small business, the availability of a bank service is almost indispensable. The source of these loans for small business is in almost every case the community bank, itself a small business. Regrettably, the flow of deposits to these small business institutions has been seriously impaired. Impaired by an incredible set of circumstances which permit financial institutions that do not call themselves banks to operate across state lines, totally unregulated, offering numerous inducements to take money out of community banks and reduce money available for small business lending.

I am, of course, referring to the "money market funds" operated by brokerage houses and even catalog order houses. The success of this unregulated banking activity is easily measured, with almost $200 billion of funds now in the hands of these private money handlers. No limits on interest, no reserve requirements, no capital requirements, no state or federal examinations, just the free market competition. By reason of my own views, I support as much open market competition as our social and political and economic structure can allow. However, it is totally incongruous that we intervene through government by regulating for the public good the 15,000 licensed banking institutions in this country while we allow a handful of unlicensed bankers to do as they please. It is a situation that our economy cannot tolerate any longer.

Of course there are no funds available for the housing industry. The monies are in the hands of Merrill Lynch, and other large financial institutions who have deposited the funds either in the major money center banks or bought private or government securities by the tens or hundreds of millions. Why would they want to bother making a $90,000 loan to build a home, it is definitely too much bother. In the meantime, the traditional relationship between inflation and the cost of money is ignored by the marketplace while free competition for the limited number of available dollars takes place.

For years, great importance was attached to the safety provided by the federal insurance of deposits, but a 10 point spread in yields can blind even the most conservative saver to the risks which accompany the "money market funds". For years, the Federal Reserve Board sought to gain an even greater control of the money supply and tried various ways to seduce or force the banking industry to become members of the Federal Reserve System, so that it could have a better control of the money supply. Suddenly, it doesn't seem to be of any concern that over $200 billion is beyond the reach of the Federal Reserve System. In effect we now have a "loose cannon" rolling around on the deck of our economic ship but no one cares as long as it doesn't roll over them.

I think Congress should care, and must care, because the nation's available loan supply is leaving the community and, therefore, being drawn out of the reach of small business and, unless this trend is reversed, the other problems in our economy, i.e. unemployment, lack of adequate tax revenues and business bankruptcy, cannot be cured. Small business needs small banks, and they in turn need the savers' money.

The second topic which I would like to call to your attention is the devastating anti-small business policy being followed by the Federal Savings and Loan Insurance Corporation. The plight of our savings institutions must be of great concern to Congress. Most of the savings institutions in this nation are mutually-owned or are community-owned capital savings institutions. The FSLIC has a monumental task on its hands due to the impact of current high interest rates on savings institutions, directed and regulated for years toward long-term low-rate mortgage investments. Naturally, under today's economic conditions, many institutions have lost millions of dollars because of the negative spread caused by the high cost of attracting deposits and the low yield on old investments.

The problem I see is that when the FSLIC is faced with the virtual insolvency of a savings institution they look for a larger institution (which is probably also suffering from the same calamity) to take over and merge the small institution into the larger one. They then proceed to inject capital into the large institution to assist in the merger and to provide fresh reserves. The result is an epidemic of mergers of community savings and loan associations and savings banks into a handful of large institutions, certainly easier to control and regulate but at what a cost to our economy. A devastating blow to small business and our economic welfare.

Recently, I saw several community savings and loan institutions merged with one of the "downtown" giants. One of these institutions was the source of financing for all the homes and apartment buildings that my partner and I built during the almost ten years I spent in the construction business. There is no way that the branches of the downtown giant are going to be in a position to respond to the local general contractors and builders the way the community institution was able to do. The personal knowledge and trust which comes from a long time association with a community is lost when second and third echelon officers and employees of a major institution become the loan officials which the small business contractor must deal with on his loan request.

If the new policies of this country are to move banking in the direction of Europe, Canada, and many other places in this world, where just a handful of banks serve the entire nation, then we certainly have had a successful start in this direction over the past two years. In Canada, approximately 15 banks serve the entire nation. Perhaps we can be left with 115, but is this concentration of money going to help the most important segment of our economy — small business? There is no way for a giant multi-billion dollar bank to economically respond to the local

builder who wants to finance one or two homes or acquire a few lots to inventory before building. The big bank wants to deal with big builders who do projects of hundreds of homes. It is a question of economy of scale.

It would seem to me that the FSLIC could assist community financial institutions that have lost their reserves due to economic conditions, totally beyond their control and not through their own mismanagement, so that they could remain in business, in the same manner that the FSLIC is helping the giants. Apparently, it is sensible to inject tens of millions of dollars into the hands of a giant association but impractical to put one or two million dollars into a community association. Of course, administration is easier when you deal with just a few giants but again at what cost to our economy.

Deregulation in the banking community is a controversial topic. Throughout the entire post-war era, we lived with a regulated banking community, and the expectations of savers were generally satisfied. The person that wished to speculate with major sums of money always had places he could invest for a higher return. "Saving" always had a special safety net surrounding this concept and it was the ready availability of this money and not how much it earned that was the prime concern of the typical saver. Today the regular saver is cheated by the artificial low cap that has been placed on the amount of savings interest that may be paid while, on the other hand, the depositor with a slightly larger sum has become a speculator moving his money, as swiftly as interest periods expire, from one money fund to another to gain an extra quarter or half percent. This combination of a half regulated and half unregulated financial sector has lead to chaos. Only the government can print money and set its value. It is a monopoly. It is not a product for competition in the free marketplace because it cannot be grown or manufactured or produced in any

way through improved productivity or with better ideas and better management. In other words, it is not in my opinion an item that can be set totally free in the marketplace. The government's obligation of establishing and maintaining the value currency has recently been somewhat ignored, to say the least. To have our government now walk away and announce that it will leave this area of the economy without guidance, without a traffic policeman, if you will, I believe will bring only greater chaos into the money markets at the expense of small business. I urge this committee to recommend to Congress that it exercise its powers in a manner that:

1) will safeguard the value of our currency

2) that will preserve the concept of community savings institutions

3) that will cause proper steps to be taken to return the $200 billion that has been syphoned into the hands of a few big giants back to the small business savings institutions that can put this money to work with America's small business people.

4) that it will send signals to the Federal Savings and Loan Insurance Corporation, that Congress desires to preserve community savings institutions and opposes the concentration of money into financial super giants.

I sincerely hope my testimony will help this committee to focus on the problem of small business' relation to small business community savings institutions. The current undermining and destruction of this sector of our economy is frightening in the eyes of many of us who understand this relationship. I feel confident that the members of this committee understand. I hope you can convince your fellow Members of Congress.

Thank you for giving me the opportunity to present NSB's view on this important topic.

TESTIMONY OF JERRY GULAN, VICE PRESIDENT, NATIONAL SMALL BUSINESS ASSOCIATION

Mr. GULAN. Thank you, Mr. Chairman, and, Mr. Fary, thank you for those kind words in favor of Mitch. He is also a household word with the National Small Business Association and with most of the small business community, due to his long service as a small builder himself, as a Government bureaucrat on behalf of small business, as a small banker and, as you say, in the Chicago area he is not unknown in the greater metropolitan area.

He does apologize. I just received a call after I got here that unfortunately he missed his plane and he suggests that, perhaps, the deregulation of the airline industry is at fault in messing up his schedule and asked that I suggest that, perhaps, deregulation of the banking industry will equally mess up small community banking and small business.

His statement has been submitted here for the record. It is an excellent statement, which is based on his own personal experience as a builder, banker, and small businessman in his own right. I won't attempt to read the whole statement and, unfortunately, I would be less than qualified to respond to some of the questions you may have about the banking industry, but the thrust of Mitch's statement goes to the fact that banking deregulation would more than likely result in concentration of banks in large money centers and large money center banks, doing away with the community banking interests and our savings and loan institutions that have historically provided, perhaps, 98 percent of the small business banking and lending needs, particularly in the areas of home building and construction, where historically a small builder every year builds 5 to 10 units, whether it be private family homes or a condo unit of 8 or 10 units, goes to his local savings and loan or small bank and gets the $200,000 or $300,000 he has needed and he has a very good personal relationship with that bank. It is almost a revolving door situation. He gets his money, builds homes or units, sells them, comes back for the next trip.

Mitch told the story at our recent annual trustees' meeting of a builder he is very familiar with, who has been doing this for years out in suburban Chicago, and as a result of the small savings and loan either being merged into a larger one downtown or going out of business, he was forced to go to a large downtown Chicago bank for his funding. This was about a year ago, I believe, and he was told by the loan officer that he had a very good record, a very good history. However, the bank could not concern itself with lending money at whatever the rate was at that time for a project that only required $250,000. Now, if this builder wanted to come back the next week and say that he needed $2½ million to build a project 10 times the size, he would be happy to service his account.

Well, this is the problem that we are getting into, and as Mitch points out in his statement, the intimate knowledge of the businessmen vis-a-vis the banker is fast disappearing as the smaller institutions are disappearing.

I will just go to his conclusions, if I may, Mr. Chairman, and then attempt to answer any questions I may. However, his conclu-

sions do reflect the opinion and the position of the National Small Business Association in this matter.

Mitch says, and I will just read briefly:

Deregulation in the banking community is a controversial topic. Throughout the entire post-war era, we lived with a regulated banking community and the expectations of savers were generally satisfied. The person that wished to speculate with major sums of money always had places he could invest for a higher return. Saving always had a special safety net surrounding this concept and it was the ready availability of this money and not how much it earned that was the prime concern of the typical saver.

Today, the regular saver is cheated by the artificial low cap that has been placed on the amount of savings interest that may be paid while, on the other hand, the depositor with a slightly larger sum has become a speculator, moving his money as swiftly as interest periods expire, from one money fund to another to gain an extra quarter or half percent.

This combination of a half regulated and half unregulated financial sector has led to chaos. Only the government can print money and set its value. It is a monopoly. It is not a product for competition in the free marketplace because it cannot be grown or manufactured or produced in any way through improved productivity or with better ideas and better management. In other words, it is not in our opinion an item that can be set totally free in the marketplace. The government's obligation of establishing and maintaining the value of currency has recently been somewhat ignored, to say the least. To have our government now walk away and announce that it will leave this area of the economy without guidance, without a traffic policeman, if you will, I believe will bring only greater chaos into the money markets at the expense of small business. We urge this committee to recommend to Congress that it exercise its powers in a manner that will: (1) Safeguard the value of our currency; (2) will preserve the concept of community savings institutions; (3) will cause proper steps to be taken to return the $200 billion that has been syphoned into the hands of a few big giants back to the small business savings institutions that can put this money to work with America's small business people; and (4) that it will send signals to the Federal Savings and Loan Insurance Corporation, that Congress desires to preserve community savings institutions and opposes the concentration of money into financial super giants.

We sincerely hope this testimony will help the committee to focus on the problems of small business' relations to small community savings institutions. The current undermining and destruction of this sector of our economy is frightening in the eyes of many of us who understand this relationship. We feel confident that the members of this committee understand and we hope you can convince your fellow Members of Congress.

Mr. NOWAK. Thank you very much.

I wonder if you can tell us within all of the three goals that you have set forward here, if we looked at the Glass-Steagall Act, and all, do you or your organization think that if commercial banks were given certain security-type powers, would that help in bringing stability to the banking industry vis-a-vis their competition with the so-called supermarkets and also the money market funds?

Mr. GULAN. I am afraid I don't have an answer for that, Mr. Chairman, but, if we may, I would ask that Mr. Kobelinski submit some responses for the record.

Mr. NOWAK. All right. We will hold the record open in case we have some other questions.

Mr. GULAN. We would be happy to do that.

Mr. NOWAK. Mr. Marriott.

Mr. MARRIOTT. I have no questions, but I appreciate your statement.

Mr. NOWAK. Mr. Fary.

Mr. FARY. No questions.

Mr. NOWAK. We wish you would tell Mr. Kobelinski that we will try to do something about the airline deregulation problem.

Next, we have from the Chemical Bank of New York, Robert B. Willumstad who is the senior vice president in charge of small business and retailing for the Chemical Bank of New York.

After the initial two testimonies, I am sure you are anxious to come forward with the story of a large bank serving a small business community. I might just mention that Chemical has opened an office in Buffalo and has provided competition to the local banks that have been there and have certainly made their mark. From what I have been hearing from our small business community, they have a very active small business loan department there, willing and able to provide the type of counsel that has enabled many small institutions to move ahead.

With that introduction, hopefully, you will be a little more comfortable.

TESTIMONY OF ROBERT B. WILLUMSTAD, SENIOR VICE PRESIDENT, SMALL BUSINESS AND RETAILING, CHEMICAL BANK, NEW YORK

Mr. WILLUMSTAD. Thank you. I would like to thank the committee for giving Chemical Bank the opportunity to present its position on these important subjects.

Chemical has a major commitment to and strategic emphasis on the small business and retail banking markets in New York. A greater portion of our earnings come from the metropolitan area businesses than any of our major competitors. With our network of 250 branches in the New York area, we have in place the delivery system which is needed to effectively service the total needs of the small business community. Despite our large size, we are very much a community oriented bank. Our branch managers are trained to behave as if they were the president of the single unit bank which their branch represents, since this is the way the consumers and businesses view them.

We emphasize service in our approach to small businesses since they are generally in greater need of service than their larger and more sophisticated competitors.

There are several reasons why we are strongly committed to small businesses. The health of the small business community is closely tied to the health of the local economy. It is clearly in the interest of our retail banking customers and ourselves to help promote a healthy business environment.

We believe that providing credit and services to small business is a vital function at Chemical and helps stimulate that positive environment. While most big banks have tended to focus their resources on the retail banking customer and larger business entities, the small business market has largely been ignored. We feel that given a fair share of our attention at Chemical, we can be very important to the small business community in helping them become more profitable, which in turn will help Chemical.

The small business market has been profitable for Chemical in the past and we envision an even greater emphasis on this segment in the future. Our commitment is not merely a matter of conjecture. We have market research which indicates that Chemical sup-

plies credit to more small businesses in New York than any other bank.

What we define as small business are firms with annual sales of less than $5 million. Most of the businesses are in the retail and service sectors with nearly equal numbers in manufacturing, wholesaling, and finance. While recent figures on the rate of business failures may be high, we feel there is still growth potential in the New York market. Specifically, the service sectors appear to have tremendous growth potential. As a result, we expect to continue our emphasis on small business lending into the foreseeable future.

The lending process is essentially the same for small business as for larger business. The risks are somewhat higher due to a variety of factors such as the relative value of a firm's assets and the quality of independent financial information. In order to lend to these businesses, a banker must be closer to the small business than the larger business, sort of kicking the tires more often.

Lending in this segment is often very intuitive, because the perceived entrepreneurial qualities, that is to say the character of the business, are relatively more important than in larger corporate lending. Personal relationships and service are the keys to credible relationships. This is one of the reasons why Chemical emphasizes the sense of the community.

There are several types of problems small businesses have, especially in trying to secure credit. Most small business is undercapitalized. That fact, along with high interest rates, makes it difficult for them to borrow. It is often left to a banker to decide if a firm is creditworthy, based upon the banker's perception of the management skills of the owner more than on other factors.

Loans are priced and evaluated the same basic way for all business. Capital adequacy, character of the borrower are all important. The pricing is generally based upon our wholesale cost of funds, or the weighted average cost of all the banks lendable funds. A certain margin added on for overhead and profit and risk factors also comes into play. The banker must have reasonably strong assurance of payback or it is reflected in the risk premium.

Most of the credit needs of small businessmen are for working capital. Our branch managers generally have the authority to approve credits of this nature and size. But, we are also better organized to provide longer term credits to this segment than are many other banks. This is an area where small businesses generally have trouble, getting a term loan which can function as new equity capital.

The SBA plays an important role here. By assuming 90 percent of the risk, they enable banks and other financial institutions to lend to businesses that might not otherwise be considered creditworthy. It is debatable if this is good or a bad thing. We certainly like to see small businesses able to borrow. But the safety net of SBA supported credit might be perceived as subsidizing less than efficient businesses, something short of a bailout. It can be argued that we could be of greater service to small business community by assisting them in obtaining sufficient capital at the incorporation stage of helping them manage their firms better, rather than be a lender of last resort.

Assessing the potential impact of the banking deregulation in the small business community is difficult. We don't feel that changes in the Glass-Steagall Act will have any effect on small business. We are not so sure about the McFadden Act. It is possible that its repeal may create more competition for small business, especially in contiguous States. There is no way to project that with any certainty. Increased competition, though, would clearly benefit small business to a degree where our relations with them could become a buyers' market.

Interest rate deregulation is clearly a two-edged sword. When rate ceilings are off, small businesses will have more options employing their earning assets, which will help their profits. But as rates go up, the cost of funds to the banks go up. This translates directly to higher lending rates. The businesses can't have it both ways.

It is the feeling of the entire business community that high interest rates are a major roadblock to growth. Often the blame falls on the banks. It cannot be overemphasized that when one sector of the economy, the Government, borrows $100 billion per year, the supply of lendable funds diminishes and the price goes up. Similarly, Government borrowing of 14 percent for 10 years leaves little hope that rates will fall below that in the next decade.

We don't feel that deregulation will have any negative effect on small business. Thank you very much.

[Mr. Willumstad's prepared statement with attachments follows:]

Prepared Statement of Robert B. Willumstad, Senior Vice President, Chemical Bank, New York

I. Chemical Bank has a major commitment to and strategic emphasis on the small business and retail banking markets in New York. A greater portion of our earnings come from metropolitan area businesses than any of our major competitors. With our network of 250 branches in the New York area, we have in place the delivery system which is needed to effectively service the total needs of the small business community. Despite our large size, we are very much a community-oriented bank. Our branch managers are trained to behave as if they were the president of the single unit bank which their branch represents -- since this is the way that consumers and businesses view them. We emphasize service in our approach to small businesses since they are generally in greater need of service than their larger and more sophisticated competitors.

There are several reasons why we are strongly committed to small businesses. The health of the small business community is closely tied to the health of the local economy. It is clearly in the interest of our retail banking customers and ourselves to help promote a healthy business environment. We believe that providing credit and services to small business is a vital function at Chemical and helps stimulate that positive environment. While most big banks have tended to focus their resources on the retail banking customer and larger business entities, the small business market has largely been ignored. We feel that given a fair share of our attention at Chemical we can be very important to the small business community in helping them become more profitable, which in turn, will help Chemical.

The small business market has been profitable for Chemical in the past and we envision an even greater emphasis on this segment in the future.

Our commitment is not merely a matter of conjecture. We have market research which indicates that Chemical supplies credit to more small businesses in New York than any other bank. (TABLE I) Our commitment is real.

II. What we define as small business are firms with annual sales of less than $5 million. The industry distribution of small business can be found in TABLE II. Most of the businesses are in the retail and service sectors with nearly equal numbers in manufacturing, wholesaling, and finance.

While recent figures on the rate of business failures may be high, we feel there is still growth potential in the New York market. Specifically, the services sector appears to have tremendous growth potential. (TABLES III, IV, V) As a result, we expect to continue our emphasis on small business lending into the foreseeable future.

III. The lending process is essentially the same for small businesses as for larger business. The risks are somewhat higher due to a variety of factors such as the relative value of a firm's assets, and the quality of independent financial information. In order to lend to these businesses, a banker must be closer to the small business than the larger business -- sort of "kicking the tires" more often. Lending in this segment is often very intuitive, because the perceived entrepreneurial qualities, that is to say the character of the business, are relatively more important than in larger corporate lending. Personal relationships and service are the keys to a credible relationship. This is one of the reasons why Chemical emphasizes the sense of community.

There are several types of problems small businesses have, especially in trying to secure credit. Most small business is undercapitalized. That fact, along with high interest rates, makes it difficult for them to borrow. It is often left to a banker to decide if a firm is creditworthy based upon the banker's perception of the management skills of the owner more than on other factors.

Loans are priced and evaluated the same basic way for all business. Capital adequacy, character of the borrower are all important. The pricing is generally based upon our wholesale cost of funds, or the weighted average cost of all the banks lendable funds. A certain margin added on for overhead and profit. Risk factors also come into play. The banker must have reasonably strong assurance of payback or it is reflected in the risk premium.

Most of the credit needs of small businessmen are for working capital. Our branch managers generally have the authority to approve credits of this nature and size. But, we are also better organized to provide longer term credits to this segment than are many other banks. This is an area where small businesses generally have trouble, getting a term loan which can function as new equity capital.

The S.B.A. plays an important role here. By assuming 90% of the risk, they enable banks and other financial institutions to lend to businesses that might not otherwise be considered creditworthy. It is debatable if this is a good or bad thing. We certainly like to see small businesses able to borrow. But the "safety net" of S.B.A. supported credit might be perceived as subsidizing less than efficient businesses -- something short of a bailout. It can be argued that we could be of greater service to the small business

community by assisting them in obtaining sufficient capital at the incorporation stage of helping them manage their firms better, rather than be a lender of last resort.

IV. Assessing the potential impact of banking deregulation in the small business community is difficult. We don't feel that changes in Glass-Steagall will have any effect on small business. We are not so sure about the McFadden Act. It is possible that its repeal may create more competition for small business, especially in contiguous states. But there is no way to project that with any certainty. Increased competition, though, would clearly benefit small business, to a degree where our relations with them could become a buyers market.

Interest rate deregulation is clearly a two edged sword. When rate ceilings are off, small businesses will have more options in employing their earning assets, which will help their profits. But as rates go up, the cost of funds to the banks goes up. This translates directly to higher lending rates. The businesses can't have it both ways.

It is the feeling of the entire business community that high interest rates are a major roadblock to growth. Often the blame falls on the banks. But it cannot be overemphasized that when one sector of the economy, the government, borrows $100 billion per year, the supply of lendable funds diminishes and the price goes up. Similarly, government borrowing of 14% for 10 years leaves little hope that rates will fall below that in the next decade.

TABLE I

SHARE OF CREDIT RELATIONSHIPS

CHEMICAL	25%
MHT	21
CITIBANK	16
CHASE	10

SOURCE: LOUIS HARRIS AND ASSOCIATES

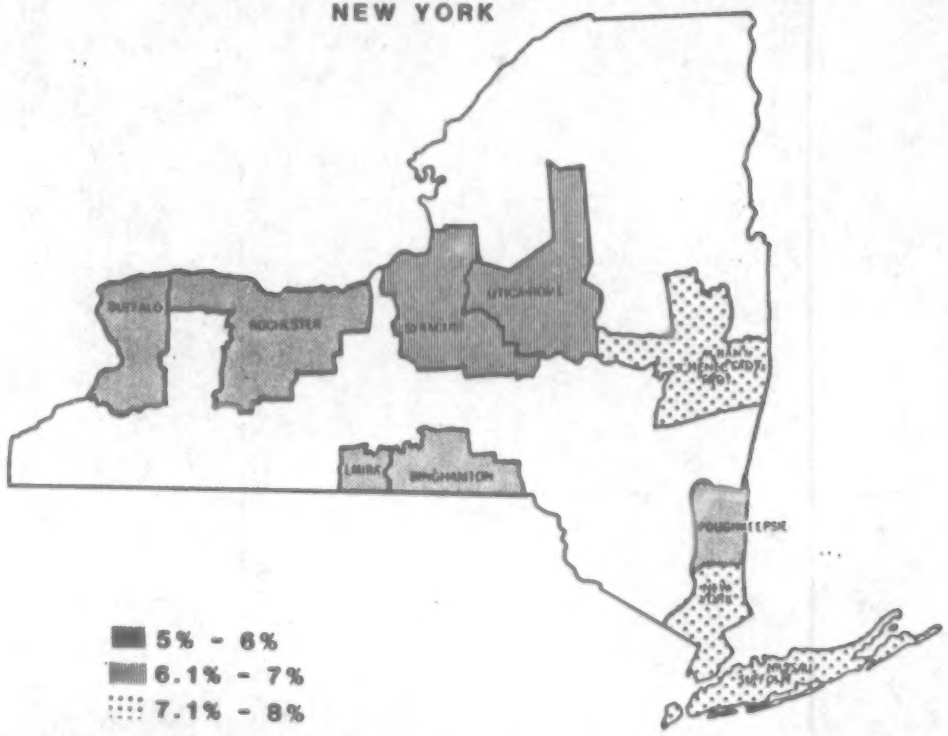
TABLE II

SMALL BUSINESS INDUSTRY DISTRIBUTION

TYPE OF FIRM	PERCENT OF MARKET
RETAIL	25%
FINANCE/INSURANCE/REAL ESTATE	14
WHOLESALE	12
MANUFACTURING	10
OTHER SERVICES	32
MISCELLANEOUS	6

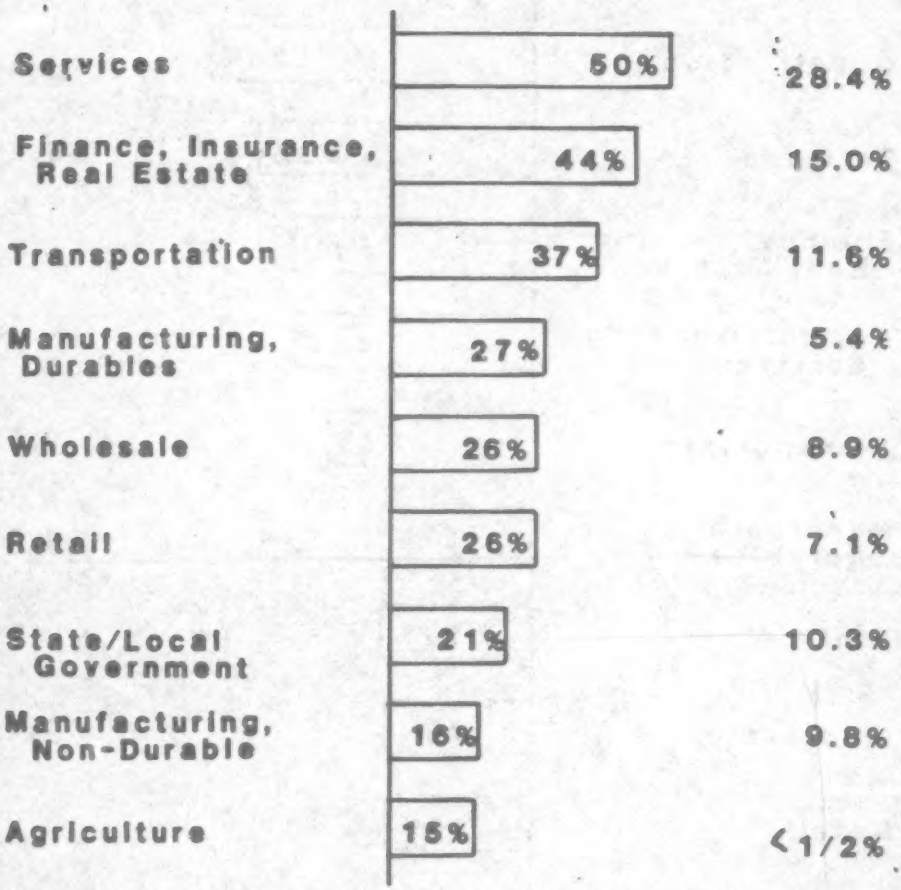
EMPLOYMENT PERCENT CHANGE PROJECTIONS 1978-1990

NEW YORK



Source: BEA Regional Projections (1980 OBERS) (July 1981)

1978 - 1990 TABLE IV
FORECAST
INCOME CHANGE
NY - NJ SMSA (NY Part)



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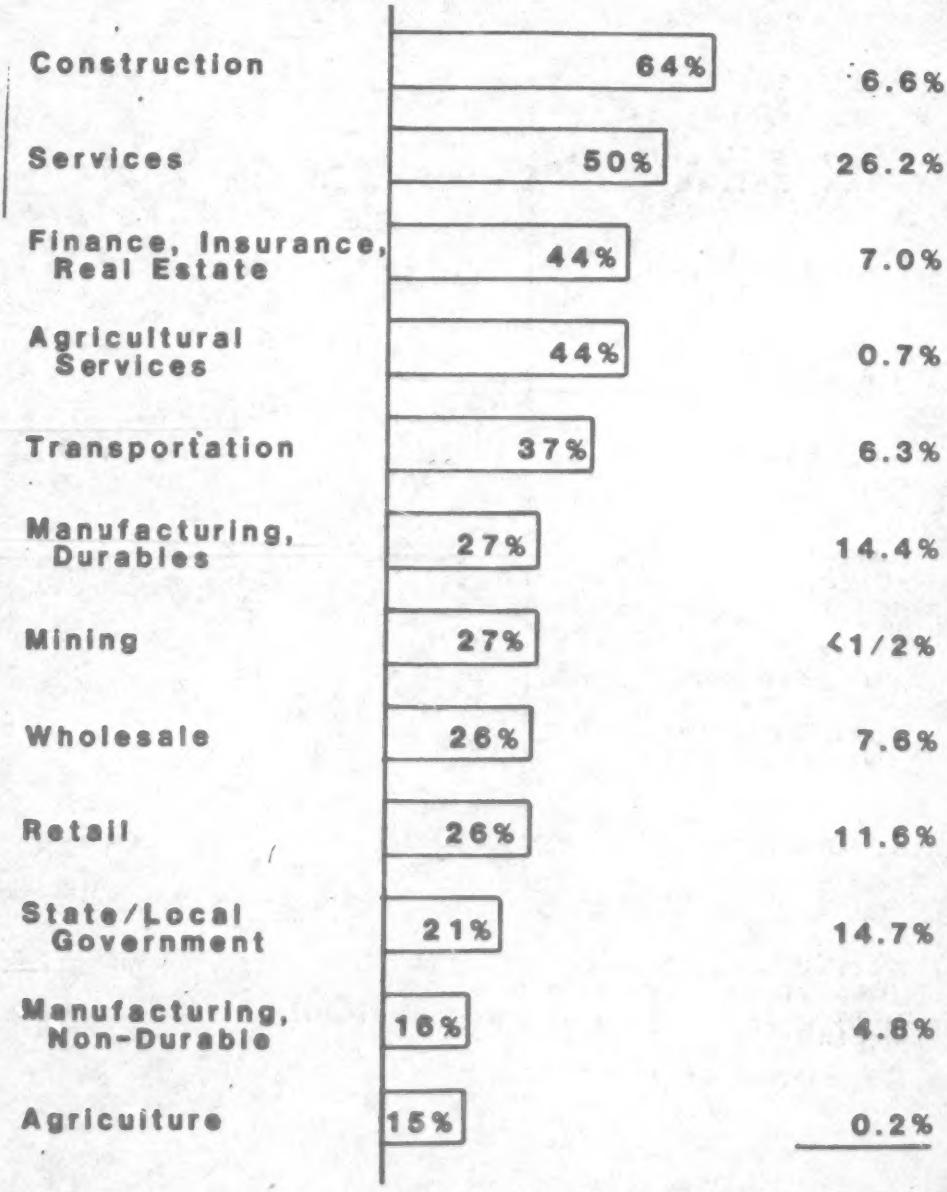
1978 - 1990
FORECAST
INCOME CHANGE
NASSAU-SUFFOLK SMSA

TABLE V



Mr. NOWAK. Thank you very much for your statement. I think it is very clear and concise and certainly one that reflects well on your organization and the place it has put itself in small business financing. We wanted to bring in a large bank that has a reputation for great involvement in the small business area and I think yours is certainly one. Your statement reflects the concern in how you have set up the offices to have a small banking environment even within a large organization, and shows it can be done if people are willing to go out there and spend the time and energy to make that environment work.

You mentioned a couple of things on page 3. You said the pricing is generally based upon our wholesale cost of funds or the weighted average of all the banks' lendable funds. Tell us what that area is today.

Mr. WILLUMSTAD. The wholesale cost of funds for the bank?

Mr. NOWAK. Yes. Do you know approximately?

Mr. WILLUMSTAD. Oh, it tends to move dramatically with some swings. My guess right now, it is probably in the neighborhood of 14-plus percent.

Mr. NOWAK. So, you are putting on top of that your overhead and so forth and what do you come out with now for a prime?

Mr. WILLUMSTAD. Our prime is 16½.

Mr. NOWAK. The risk premium would be because of the uncollateralized loan going out for working capital or whatever?

Mr. WILLUMSTAD. The risk premium is uncollateralized, but I think it is also important to understand that in the small business marketplace, it is really an issue of management, of ability and the quality of the financial information which a bank has to deal with. It is very difficult to make credit decisions with information that may not be adequate for some of these types of transactions. It is characteristic of the small businessman himself and the nature of his business not to be able to provide that type of information.

Mr. NOWAK. You have mentioned also that you deal with the SBA quite extensively, I understand.

Mr. WILLUMSTAD. Yes.

Mr. NOWAK. And probably more than any other financial institution have looked at this guarantee program that we have out there. The 90-percent guarantee, I would think, gives you some relief, at least from the risk premium addition to the loans——

Mr. WILLUMSTAD. It does.

Mr. NOWAK [continuing]. And you question whether or not you could help them more by assisting in obtaining sufficient capital at the incorporation stage and helping them manage their firms better, which is a function the SBIC's have. When they loan money, they try to get into it to a much greater degree. They take a bigger risk portion of their portfolio in many of these instances. Even with the 90-percent guarantee, although, if that weren't there, wouldn't this cause an additional burden, and you would say, "Well, let's make the effort to live with this guy, thinking in terms of manpower."

Mr. WILLUMSTAD. That question needs a couple of answers. No. 1, I think SBA loans, generally speaking, become much more equity capital than they do working capital. I think that I would admit that many loans probably would not be made without the SBA. To

answer part of your question, though, I don't think the bank puts forth less effort for the borrower just because he has an SBA guaranteed loan. We go through as great a scrutiny in management of those loans whether they be SBA guaranteed or not. But I do feel the SBA does provide a cushion of comfort to the banks in its initial lending and credit decision.

Mr. NOWAK. Do you have any idea of approximate failure in comparison with a regular small business loan or an SBA guaranteed loan.

Mr. WILLUMSTAD. I don't have the figures, but I would say that the failure on SBA guaranteed loans generally would be considerably higher than our own experience with non-SBA loans.

Mr. NOWAK. What percentage of all your small business loans would be guaranteed?

Mr. WILLUMSTAD. SBA guaranteed? I believe we had about—I am not sure. I would hate to be quoted. My guess is about 30 or 40 million dollars' worth of SBA loans, a relatively small portion of the total portfolio. Small business loans are in excess of $600 million.

Mr. NOWAK. You know, with the changes that we are going through everybody is trying to figure out why the interest rate is sticking, with the fall of the so-called CPI. Traditionally that has had a relationship with some 3, 3½ percent, I guess, as you go through the fifties and sixties and seventies. Now, the administration has brought down inflation and the rate stays. And I am wondering if you could comment upon this and what I perceive anyway as a tremendous change in structure, where you have the dollar now going to a C. & A. account or money market fund and drawing it out of the traditional institutions that held the money for investment in housing and small business and so forth. I am just fearful that even if we have success in bringing down the deficit that we still have out there in the structure, a change that will permanently keep that interest rate much higher than traditionally has been the rate, as the economy goes up and down by itself and inflation and unemployment fluctuates. Do you have any comment on that generally?

Mr. WILLUMSTAD. There are a lot of smarter people than I who have trouble answering that question. But I think, generally speaking that there is a significant change in the structure. Part of our feeling about deregulation, obviously, is that we would like to be able to participate in some of that change. I do feel strongly, though, that Government borrowing has probably had more of an impact upon the availability of funds and, consequently, high interest rates, than even the change in structure. But it is a point well taken that money market funds have taken money from banks at relatively low cost to banks and brought them back in at much higher cost. Our feeling, especially concerning small business, is that the businesses provide a good source of low-income funds for banks because of their need to do business in the ways in which they do. Consequently, it has been a significantly profitable market segment for us and we think that is why we can continue to support it.

But in terms of why prime and why cost of funds are so high, I think it is very much a function of availability of money based on Government borrowings, budget deficits.

Mr. NOWAK. You know, you can look at that and go back through the forties, fifties, and sixties and see that our national debt at one time was very high in relation to our gross national product. I don't know what other source you could measure it against, but in the late forties and early fifties, you were dealing with tremendous growth in this country and you had borrowings that were astronomical in terms of percentages as against our gross national product. In addition, everybody was horrified by the projected $1 trillion number, but at one time the percentage of debt as against the gross national product was as high as 55 percent and now it is down to somewhere around 30, a little over 30, 31 percent. So, we really reduced the debt as a percentage of our gross national product.

It just works all different ways. You have had a high amount of debt and low interest rates when the Government was borrowing a higher percentage than they are today. You know, we talk about the debt. Certainly, you know, it plays a role, and I think everybody wants to see that debt come down, if not for financial impact, at least as a psychological lift for everybody to reconsider where the price of money is.

Now the regulation is gone, which really set a floor for people to invest their money, and set up a system where housing could be leveraged by every working person in the United States, we have taken that away. We have taken that out of the economy.

Mr. WILLUMSTAD. I think the response to the removal of regulation Q or the relaxation of regulation Q is very much the function of giving the consumer and the small business person, who never had access to markets, a situation where they could obtain what we would categorize as market rates for their deposits. So, it has been a situation where, I think, the regulatory environment has responded to the consumer, who on one side would like to be able to get access to high returns and high yields on his money, and where big businesses have had that opportunity with large CD's and so forth.

So, it is a little bit of a whirlpooling kind of effect. Too many people chasing the same dollar, I suppose. I think there is also a confidence factor, too, in the capital markets that possibly inflation may not remain as low as it has been for the near term and it could rise. As I say, I am not an economist. I suspect there are a lot smarter people around to answer that question than I.

Mr. NOWAK. I think it is going to be fascinating in the next year or two to see what does happen because it is going to determine, I think, over the next two decades, whether people are going to be able to afford housing, and if small business is going to be able to obtain the kind of dollars they need. In fact, if your demands are even going to grow with the size of the rates.

Looking at your industry, unless something is done in the deregulation area, how do you foresee you are going to be able to compete with these so-called supermarkets, including, of course, the CMA's, where you can get everything from your 13, 14 percent interest, plus instant liquidity, plus a VISA card, plus a statement for tax purposes, plus transfers to and from stock accounts. I assume when Sears gets into it you buy the tires and the cars and the insurance and baby shoes and everything else by telephone.

This will have a terrific impact on the whole technical innovation field, which makes them able to operate in your community without the overhead that you have. How do you foresee that playing out?

Mr. WILLUMSTAD. Well, I think without the commercial banks being allowed to compete on an equal footing, it would be very difficult for us to compete and, obviously, that puts the banks at a significant disadvantage. I think this ultimately will have further negative impacts on the consumer and the potential small business person who will continue to require the banks to provide the traditional services that they are dispensing in cash and handling business transactions, aside from their lending functions.

Consequently, the unfair competition or the lack of the banks to be able to compete with Sears and Merrill Lynch on an equal footing certainly will have a continued negative impact on the small business and retail community.

Mr. NOWAK. So, unless you get some type of relief, whether it be——

Mr. WILLUMSTAD. I think the S. & L. and the thrift industry is a good example of that.

Mr. NOWAK [continuing]. Through the McFadden or some other avenue, I would think that you will have a further drain because you will have tremendous piece of the action from the borrowers' side or you are going to be a great lender, but I don't know about the deposit side.

Mr. WILLUMSTAD. Well, the problem, of course, is as those institutions continue to take lower cost funds from the banks, that raises our cost of money and, consequently, it will be passed along to the borrower.

Mr. NOWAK. Can Chemical borrow from the mutual funds?

Mr. WILLUMSTAD. Yes.

Mr. NOWAK. What rate do you have to pay?

Mr. WILLUMSTAD. They traditionally are market rates. I am not prepared to quote whatever the rates are.

Mr. NOWAK. Then that becomes your cost of money or mixed cost of money.

Mr. WILLUMSTAD. Yes.

Mr. NOWAK. Well, that is why I just think the structure has mandated a higher rate forever and there is tremendous economic ripple effect through not only the small business community, but the American dream of owning a home and everything else. We are going to have delay those kinds of things much, much longer. You are going to delay investments and, you know, what is the use of investing in a small business to make 25 percent, when you can perhaps get 16 to 18 percent without risk. Unless going to a small business can generate some 35 to 40 percent of profits, why kill yourself through all the risk factors to try to reach that goal when the structure is such that we may be looking at this kind of rate as a permanent thing.

Everybody used to think well, if I invest this money, in 15 years I will double it. Today what is it? Four years and 6 months and you have your money doubled. The other question is: Is this where we want to go with passive income and have that doubling every 4½

years and squeezing the economy that tight for so long? There is always another side of anything we do here.

I want to thank you for your testimony.

Mr. Marriott.

Mr. MARRIOTT. Thank you, Mr. Chairman.

We have heard some testimony today and in the past that one man's prime is not the next man's prime. Some studies that I have seen from other committees claim that where the prime was, say 17 percent, loans were actually being made and deals cut at four points below prime. Do you have any evidence of any of this type of thing going on? Does this prime cutting business take place in New York?

Mr. WILLUMSTAD. Well, that is not an area of my responsibility, so it is pretty hard for me to respond to that. I would say, generally speaking, obviously, that the lower pricing is a fairly complicated issue as it relates to cost of money, terms, conditions, contractual agreements between the borrower and the bank. All have significant impact on the pricing of loans. So, I can't answer that specifically because it is not my responsibility, but lower pricing is a fairly complicated subject in that there are a lot more issues than the rate itself that meet the eye. There are often significant fees to large borrowers and while the initial rate or the price charged may seem lower than it may to others, there are a lot of factors such as compensating balances, which may be kept by the borrower, which adds to the yield to the bank, along with other fees and other services. It tends to be a relationship pricing as opposed to a transaction price. It is a difficult question to answer easily and, again, not having first hand experience with large corporate——

Mr. MARRIOTT. Who, at your bank, would be the best person to respond to a question of that nature?

Mr. WILLUMSTAD. Either one of our senior credit officers or the head of corporate lending.

Mr. MARRIOTT. Do you have any information as to what the risk premium has traditionally been for small businesses? As I understand the system now, the inflation rate is roughly 7 percent. You figure there is probably a profit margin in there and on top of that we have about 6 percent, the so-called risk volatility premiums, the uncertainty factor, which is pushing the rate up to about 16½ percent, when in all reality, it probably ought to be about 10. On top of that, are there other small business risk premiums? When you look at your portfolio of small business loans, what is the average small business risk premium on top of what you might offer with a larger business or more creditworthy customer?

Mr. WILLUMSTAD. Well, for small business, generally speaking, I would say that the risk premium, so categorized, would be probably 200 base points over what the prime rate might be. So, if the prime rate is 16½ percent, small business may pay about 18½ percent or thereabouts. It could be higher. It could be lower, depending on the credit worthiness of the borrower.

Mr. MARRIOTT. Are most of your loans today to the big lenders being let out at prime? That 16½-percent figure, is that the average interest rate of most of your loans?

Mr. WILLUMSTAD. Again, I just can't answer that question.

Mr. NOWAK. We could, Mr. Marriott, leave that open and we could submit that to the bank.

Mr. MARRIOTT. I think it would be helpful to know exactly, rather than just dealing in vague generalities, what the policies of the banks are. We hear rumors. We would like to find out whether or not they are true. I would like to get some indication from your bank on the percent of your loans going out at prime, who they are to, and what percent are going out at less than prime. As for the small business loans that you have, what are their borrowers paying and why? I mean, I assume there is an additional small business premium, but I don't know how you determine that. It would be interesting for this committee to know what the add-ons are to your actual wholesale cost of funds.

Would it be possible to get some information from your bank in terms of how that works or is that a trade secret?

Mr. WILLUMSTAD. It is not a trade secret. I don't think so. I am sure the bank can submit some information. Again, I don't know to what degree.

The risk factor, at least from our perspective of lending, is very real. I think plenty of national statistics referring to business failures would indicate there is a significant risk in lending to small businesses. That is built into the pricing without any question. Again, to be specific about how that is determined, the comment in my statement as being somewhat intuitive, it is just very difficult to assess. What we do is to assess what is the risk factor and attach a price structure accordingly. But the competition would have one bank come in and price it dramatically different than another bank and we have seen that in many markets besides small business. What we call the middle market in New York City has become a tremendously competitive environment, which has literally pushed pricing rates down because of the competition. It is a very profitable marketplace.

Again, it is not so much a trade secret, but you would probably get different opinions from different institutions.

Mr. MARRIOTT. Just one other question. Do you think a national usury law that is attached as a percentage of CPI would be a good thing, a bad thing, or indifferent?

Mr. WILLUMSTAD. My first reaction to that would be that I think it would be a bad thing, based on experience in New York State, where for many, many years we had a fairly restrictive usury law. I think ultimately what it did was it not only made it difficult to lend, but literally cut off the availability of credit, whether it be in the housing marketplace or in the installment lending marketplace, hurting auto sales and housing starts and home sales.

Mr. MARRIOTT. That wasn't attached to anything. That was just a make of the usury——

Mr. WILLUMSTAD. That is true. I am not sure exactly what the impact would be attached to the CPI, but again, if the CPI, in effect, were pegged or at such a level that was significantly below the bank's cost of funds, because there may or may not necessarily be a relationship between CPI and the banks cost of funds, again, it could severely curtail the credit availability to consumers and small business people.

Mr. MARRIOTT. I guess one of the things I am having difficulty with is that so much of the interest rates are psychological at least right now. If, in fact, the inflation rate is getting down to the 4-percent level and we are fiddling around with 16½ percent prime, using the Government as a whipping boy and fiscal policy as a whipping boy and Volcker as a whipping boy. There has to be more to it than that, it seems to me. The reason your cost of funds are high is because you are paying people more money to put their money in your bank, aren't you? We have gotten into a situation where as long as you are offering 14 percent on savings accounts, you have to charge me 18½ percent or 20 percent to borrow the money. So, isn't there some way, other than psychologically, that we can get back to a true, fair, honest rate of interest in this country?

Mr. WILLUMSTAD. Well, again, that is a difficult question to answer. I would only say it would be nice. Our bank or any bank would have a difficult time if we offered 10 percent interest on rates, when you can purchase Treasury bills from Uncle Sam and earn 13 to 14 percent as a yield.

Mr. MARRIOTT. Still, the whole system really is a largely psychological situation.

Mr. WILLUMSTAD. I would agree with that.

Mr. MARRIOTT. Especially for small business. He is out there trying to make a living and he has all these psychological factors to deal with. I don't know where we are going to go.

I appreciate your testimony and certainly the willingness of your bank to help small business. If you could respond with some of the answers to these questions, I would be most happy to have them.

I appreciate it, Mr. Chairman.

Mr. NOWAK. Thank you very much, Mr. Marriott.

Mr. Fary.

Mr. FARY. Thank you, Mr. Chairman.

Mr. Willumstad, thank you for your very fine statement. You point out that Chemical Bank has a commitment to small business. We have listened to previous witnesses that point out that multibillion dollar banks prefer to deal with large transactions over small projects. For example, it has been suggested that a large bank would be less responsive to a builder who wants to finance only two homes and more open to a builder who wants to finance projects of hundreds of homes. This is a case of economy of scale. How do you respond to this?

Mr. WILLUMSTAD. Well, I am strongly opposed to that statement. Chemical Bank's experience in New York City is a very strong statement in that we have 250-odd branches around the New York metropolitan area. The strength of those branches and the profitability of that system to Chemical Bank is very much dependent on the retail and small business customer. We find it a very profitable market. There is no question there are economies of scale, but, as I say, I think the competitive environment with so many banks chasing the same customers there are only so many large, so-called large borrowers or large customers and there is a tremendous amount of competition. While there are economies of scale, we feel very strongly that there is a very, very healthy strong market and

opportunity for banks to service the small businessman and the retail customer.

I can only repeat what was in the statement. I feel very strongly about it and I am very committed to it and we have some 25 percent of the market in New York.

Mr. FARY. Thank you very much.

Mr. WILLUMSTAD. You are welcome.

Mr. FARY. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you very much.

In today's paper there was an article concerning the interest rate problem saying that the Reagan administration is getting a little upset that interest rates are high, while at the same time telling the Fed to keep the money tight and speculating that some time in the next few months, because of the pressure and the economy, there may be some drastic changes put into the system if the interest rate doesn't come down. On the one hand, of course, tight money is the policy and on the other hand, it is not going to come down until, as Mr. Marriott has suggested, that or some other mechanism is found to hold the interest rate at a lower level.

I would like to just throw that out to you as a general question. If you were faced with that decision, maybe you could go back to the bank and talk to some of the economists there, because it is a very broad question. What would be the impact of something like Mr. Marriott suggested or is there another method that perhaps you could suggest to the administration, which would benefit the small business community. I am taking it for granted that it is going to fail and we will still have a deficit after the budget. After the six votes we have on the budget come out, you are still going to have a deficit of $100 billion.

Mr. WILLUMSTAD. Well, that is certainly a broad question. I would certainly have to think about it. As I said, not being a professional economist, I would probably reserve some of those remarks to the economists.

Mr. NOWAK. We are trying to get some realistic——

Mr. WILLUMSTAD. No, I understand——

Mr. NOWAK [continuing]. Input into this whole thing and I don't know if——

Mr. WILLUMSTAD. It is very difficult and again, I am probably speaking more from my own personal opinion than necessarily the position of the bank, but my own feeling has been through experience that mandated regulations tend to maybe address the problem for a very, very short period of time and ultimately they——

Mr. NOWAK. I know, but you know, when you look at it, we are not moving in a very good direction now, despite all the optimistic promises that came out last year. It has only been a year and I, for one, think that all of these promises of glory and change were more political than they were realistic because this economy doesn't absorb, and the marketplace won't absorb all of this in a short period. You know, every time you turn around, it is 3 months away before inflation goes away and interest rates come down and we will have this tremendous boom. Then it was July and then it was September and then it was December and then it was, certainly, by the spring. That is probably one of the big problems psycho-

logically, because we just can't do that. We just can't change this economy in that kind of a period of time.

When we look at the forties and the fifties and the sixties and seventies, there were opportunities presented which caused a tremendous increase in the so-called standard of living for the average American and because of that, everything else grew proportionately. When that happened, we said, if we only change the Tax Code and put more incentives on the supply side, all of these other problems would be solved. Yet, there was no impact on the market structure itself, when you had large inventories out there and you had those inventories backed up to the warehouses and you had the manufacturing sector starting to lay off because they were operating at 67 or 70 percent, despite the incentives to build new factories. You get 15 percent and you get 11.6667 percent. It still wasn't the determining factor to affect the whole marketplace.

Those inventories just took an awful long time to wear down and I am not sure they are all down yet. The administration is telling the Fortune 1,000 companies, well, you have to invest, we put all of the supply side initiatives in there for you, and they are saying, well, as soon as we get back up to 85 percent with our present capacity, we will be able to work within the system. And I don't know. I can certainly understand the banks' competitive posture now, that you have Merrill Lynch and everybody else competing for the funds, and I don't see any real long-term growth potential, unless you are able to compete for the dollars that are out there.

We had been giving people, the average worker, the ability to leverage, at least in buying a home. If the only entrance he had into the free enterprise system was buying that home, at least he had that and he had the interest and he had the ability. We have taken that away with the present structure, and at least 90 percent wanting to buy that first new single home, can't refinance. So, we are sort of left without anything and, yet everybody is decrying how terrible the forties and the fifties and the sixties and the seventies were in this country.

With the regulation Q, there is no question, you either have to have relief or you are going to go out of business. On the other hand, if we give that relief—and the administration's position is the money markets are wonderful instruments because they help people invest—you have changed the basic structure. So, if we don't find a way to cap that, as the former SBA Administrator mentioned in his statement, if with all of these changes, we don't find a way to do that, are we ever going to be able to get the so-called standard of living moving again? I don't think it is as philosophical as this long explanation I tried to go through, but I think it is a practical way of seeing that something structurally has to be done. I hope that the banks would, as they have in the past, give some thought to that and see if there is some other answer than to say, let's wait.

You mention in your statement there is 14 percent money out there for 10 years now. We are going to wait 10 years for this thing to turn around. Are we going to make our standard of living the equivalent of a European community where you buy your first apartment when you are 44 years old after you have saved 25 years of your life, or are we going to keep that standard moving as we

have? This is a very broad area because there are so many differences of opinion within each individual little structure that is involved. That is really, I guess, why we are stuck initially in trying to bring all of this out.

But it would be interesting to hear what your economists say. I read the newsletter once in awhile, too.

Mr. WILLUMSTAD. Well, we will try and get you an answer.

Mr. NOWAK. I appreciate your testimony and if you do have the opportunity to go back and sit with some of your economists there, I just wondered if there is anything else we can do on the magic of balancing the budget. I, for one, after going through those figures on the booms and the busts, have real doubts whether other economists agree with this, that your financial impact is as heavy as people deem it to be. I just think that the change in the structure has now let us out of that. I think the impact would have been heavier if reg Q would be at 5¼ percent and you were getting money. Then the impact is heavier. Without that, we are going to have a much less favorable impact, even if we could balance it.

At least, I appreciate your coming here and hearing not only from us, but from the other witnesses. Now, you can see where their concerns are coming from. On the other hand, I just felt we would like to balance the hearings by bringing in a large institution, whom I believe has made a real concerted effort to serve the small business community not only in the city, but certainly throughout the State. Hopefully, we will find a way for you to be encouraged to do that in the future.

Thank you very much.

Mr. WILLUMSTAD. Thank you.

Mr. NOWAK. Our next witnesses are from the National Federation of Independent Business. Jonathan A. Scott is present, along with Mr. Dennis, who is in charge of research for NFIB. First of all, I welcome Dennis back. I understand you are recuperating from your surgery and we all want to wish you a speedy recovery.

Mr. DENNIS. Thank you, Mr. Chairman.

Mr. NOWAK. Mr. Scott is the assistant professor of finance at Southern Methodist University. He served as a consultant to NFIB.

Mr. Scott.

TESTIMONY OF JONATHAN A. SCOTT, ASSISTANT PROFESSOR OF FINANCE, SOUTHERN METHODIST UNIVERSITY, AND CONSULTANT, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. SCOTT. Mr. Chairman, the testimony that I am going to give this morning is slightly different from the others in that it is based upon a large sample of small businesses. So, what it is providing is a general overview versus some specific cases and it may differ somewhat from problems that the other witnesses have given. That doesn't mean that those problems aren't important, but what I am going to do through this testimony is summarize it and have you go through the tables with me, where appropriate, so that we can have some data and see how it corroborates with other statements that have been made thus far.

I would like to make a comment about the data. It comes from two surveys that the National Federation of Independent Business

has conducted. One is an ongoing survey, which is entitled "Quarterly Economic Report" and in this report about 7,000 questionnaires were mailed out and we will get 2,000 responses and the questions have to do with plans and actual changes in inventories, capital expenditures, sales, borrowing activity, and price changes.

The other survey was a special survey called "Credit Banks and Small Businesses." This was conducted in April 1980, and there were about 4,000 respondents and this dealt with questions about loan terms, credit availability, and satisfaction with banking services. So, we have a rather large data base and a broad sample of small businesses that deal with anything from Cadillac dealers that are doing well or struggling Chrysler dealers and from high technology small businesses to very small family-owned retailing businesses. So, we have a very broad perspective from about a 500,000-member organization and the membership seems to be reasonably representative of the small business community, at least with respect to data provided in county business patterns. I think that is worth noting.

What I want to do first is talk about the characteristics of these small business borrowers, and who they are. If you could turn to table 1, I think I will start there and talk briefly about their characteristics in these first few tables. This is after the written portion of the statement.

As you can see, most of the borrowing, as indicated in the survey, comes from commercial banks, 90 percent of the short-term borrowing, whereas it declines for the longer term. Private individuals become a more important source for longer term borrowing and the Government borrowing. That source is primarily Small Business Administration loans. As suggested by our previous witness that most of this is a larger percentage for longer term financing.

But banks are the important major source of small business loans. With respect to deregulation and the ability of savings and loans to offer business credit, you can see as of April 1980, which was before the Deregulation Act went into effect, they only provided about 1 percent of the funds for small businesses for shorter term loans.

We have a new survey on "Credit, Banks and Small Business" that was just completed in April. We don't have the data available yet. Perhaps, that will shed some insight about the impact of allowing savings and loans to supply business credit.

On the next page, table 2, I just want to talk briefly about how many of the small businesses are borrowing on the basis of our data. What it suggests is that it varies anywhere from 40 to 51 percent of the small business community. In fact, it varies with the business cycle, with all borrowing. The highest percent of the membership that was borrowing was 51 percent and 50 percent in the first quarter of 1980.

Then, as we moved into the recession of 1980, this fell dramatically, as with all other business borrowing. It peaked again in mid-1981 and then it has fallen off dramatically again in the current recession. It seems to move with the economy.

In the survey we were able to compute a medium size loan and that was about $20,000 per loan, which suggests that aggregate small business credit demands vary between $28 and $35 million

over the last few years. And this amounted to about 25 percent of total short-term loan demand in 1981.

On table 3, there are a few important points that I would like to bring out. That has to do with who these borrowers are. It turns out that the small business borrowers employ more people, and have greater capital expenditures. They are growing more rapidly and have higher sales. The importance of this table is that the borrowers are the larger businesses and they are the movers and shakers, if you will, of the small business economy. These are the people that are growing, that are contributing to our GNP, contributing to innovations and additional employment.

That is not to say that the nonborrowers are not important, but these are the larger businesses and where borrowing costs will have, as we will see, greater impact on them than the nonborrowing ones.

So, that would wrap up what I have to say about the characteristics. I would like to talk briefly about credit availability. The tables are there, submitted. I don't think I will go over them. They are a bit confusing and it would take more time to go through than I want.

The major point I want to make is that credit availability, that is the ability to obtain funds, has not been a problem for the NFIB membership. I think you have mentioned that this has come out before in the "Credit and Bank Survey" in 1980, and just about 80 percent reported that all or most of their credit needs were met. A similar percentage reported that they had 90 to 100 percent of their original requests granted. So, it hasn't been a very big problem.

The impact of availability on expansion plans is another question asked in the survey. Has current availability affected your plans to expand? Has it caused you to postpone, reduce, or scale back your expansion plan? There is a similar question as to cost. OK. So, we are trying to get at the difference between the cost of funds and availability of funds on plans for expansion.

Now, in one of the tables I have suggested that over 55 percent, or over half of the people, reported that availability affected their expansion plans, but that is somewhat misleading. because availability was very highly correlated with cost, somewhat similar to someone saying, well, I can't get any mortgage credit at 17 percent. It is really not a question of not being able to get it. You can't afford it. So, if you can't afford credit, it is really not available.

And if you control for cost, that is, ask how many people had problems with availability and were willing to pay any price, that turned out to be only about 3 percent. That suggests that that doesn't seem to be a very big problem in a small business borrowing community.

I did look at the characteristics of these people who reported availability problems and there didn't seem to be any systematic relationship with a degree of branching, whether it was statewide or limited, or with bank size or region of the country. It turned out that it was more a function of risk and the best that I could discern from the data was that it was really a divergence of opinion, that the business felt it was less risky than the bank did. So, it was a question of price rationing them out, instead of availability.

One other important conclusion about availability is that through some other statistical analysis, I was able to find that new businesses and rapidly growing ones had a lower probability of having availability problems. That is important for growth of the small business sector in the economy.

The next item that I would like to talk about is the cost of credit that has been referred to throughout the morning, and that would be on table 8. What I have on table 8 is a distribution of interest rates paid for these various surveys. The fourth quarter of 1979 and the first quarter of 1980 is from the "Credit and Bank Survey" and the remaining data are from the "Quarterly Economic Report," where we asked, "What is the interest rate you paid on your most recent short term loans?"

One thing that we find is that a dispersion of interest rates paid has narrowed quite a bit. What that reflects is the drying up of cheaper sources of funds, because many firms were able to borrow against the cash value of whole life policies, but they had run out. That source is gone now. So, we see a convergence of the distribution toward the 16- to 18.9-percent range.

Probably more revealing is the computation of the average rate paid and the prime rate at the end of each quarter. What somewhat startled us initially was that the average rate—mind you, there are people paying way above prime and way below—but the average rate has averaged within plus or minus 2 percent of the prime rate.

Now, we haven't been able to adjust for fees or compensating balances, but the survey suggested that those weren't, at least for our respondents, very important issues.

So, what are they paying? Within plus or minus 2 percent of the prime rate. In fact, in our latest survey we are able to determine that only 30 percent of the businesses sampled were paying the prime rate or prime plus something.

On the next page, I just want to mention briefly about the average interest rates by some various characteristics and, in particular, some bank structure characteristics, market, region, and branching laws. What you can see consistently across is that rural businesses borrowing from rural banks have paid less than metropolitan banks, city banks, and New England and Pacific region borrowers have paid more than the rest of the country. I would argue that this is primarily due to differences in overhead costs, differences in rent, differences in wages. They are in both a rural/metropolitan basis, as well as regionally.

Also, note that borrowers from statewide banks are paying more than the borrowers in limited or unit branching status. We need to be careful about this because an additional analysis of the data suggested that there were fewer loans rejected by statewide banks than limited or unit. So, what that means is that with these fewer rejections, there is more risk and that would, in some sense, justify this higher premium.

What I suspect is more important is looking at the differentials between rural and metropolitan and the New England, Pacific, and the other regions, the statewide and the limited and the unit, because those have been narrowing over time. That is from late 1979, early 1980 through the end of 1981. I suspect what that reflects is

penetration of money market funds into rural or smaller markets. They are competing for deposits and these smaller banks are having to pay more to keep their money and, therefore, it is reflected in higher rates. So, I would attribute that, I suppose, to innovation and maybe not directly to deregulation, that being changes in reserve requirements and interest that can be paid on various savings deposit categories.

The next item that I want to talk about is bank services and how the membership in these surveys rated banks and what was important to them and how the banks actually delivered on these services. Again, this was as of April 1980, and what may be interesting is what happens now in April 1982, with a continuing change in the financial markets.

As far as the desired attributes or those characteristics that they deemed most important in their banking relationship, the two most important were that the bank knows its business and has a reliable source of credit, clearly the most important. And then the second tier of characteristics that were most important included, has the cheapest money, accessibility, wide range of services. We find these numbers to have important implications in that nonprice aspect of banking services is very important. So, if we try to measure the impact of deregulation by just looking at interest rates, it is going to be a little bit difficult.

In fact, some of the other witnesses suggested that there is an intuitive aspect in making the small business loans, so that the cheapest money is not based on this sample, one of the most desired attributes.

As far as ranking the attributes, which is on table 11, looking at good and above average, the ones that—this is looking at delivery; how well do your banks deliver on the things that are most important to you. We find that there are several that cluster together, including "knows you and your business" and "reliable source of credit." But interestingly enough, the items where small businesses ranked banks as delivering best is on "having a wide range of services" and "easy to get to." I find that interesting because those aren't directly related to personal contact. It has very little to do with this personal contact.

Nonetheless, of the desired attributes, the top and most important ones seem to be delivering good or above average. We have looked at this delivery by bank market, rural versus metropolitan, small versus large banks and degree of branching and have found that rural banks tend to provide better service than city banks, smaller banks better than larger banks, unit and limited banks better than statewide. There is a greater percentage who rank it good or above average.

Again, you know, this was as of April 1980. What happened in the intervening 2 years will be very interesting to determine, once we have that data in at the end of next month.

Nonetheless, the data suggest that small businesses are reasonably happy with the services that are being offered to them.

The last item that I want to summarize has to do with the cumulative impact of high interest rates on the small business community and, perhaps, draw some conclusions about what might be the most important problem for small business, based on the survey

data today. And for this, I would like to direct your attention to chart 1, particularly the last three pages of the statement.

In the quarterly economic survey there are questions asked about the percent of borrowing, about is credit easy or harder to get and what is your most important problem. And what we see in chart 1 up until about mid-1980 is that financing costs ranked as the most important problem and credit being harder to get moved pretty much together. Again, if financing costs are too high, if you can't afford money, it is harder to get. So, that correlation isn't too surprising.

But what happens and what is very dramatic is, toward the end of 1980, financing costs is the most important problem to small business. It keeps rising to the highest numbers ever, the highest percentage ever, while credit being harder to get is falling. So, we get this divergence. This hasn't occurred since the survey started in late 1973. Why? Why has this happened?

I will try to deal with this as we are looking at the next few charts. Chart 2 looks at net earnings change. In the survey the respondents report whether earnings the last quarter have increased or decreased, relative to the previous quarter. So, are they higher or are they lower? What is being graphed there is the percent higher minus the percent lower.

What we find is, up until this period, about 1980 for borrowers and nonborrowers, it was approximately the same. They moved together, sometimes higher, sometimes lower for the borrowers, but after about mid-1980 or early 1980, what happened is that nonborrowers' net earnings change has been higher than borrowers. What this represents, I would argue, is the cumulative impact of higher interest rates, starting in 1978, that carrying costs or just paying the interest has had a greater effect on these businesses, on the borrowing businesses, and they have not been able to make this up through additional sales volume, and they have not been able to make it up through price increases. I would refer you to the next page, chart 3 and chart 4, to substantiate those points.

In chart 3 the question has to do with the dollar volume of sales, increasing versus decreasing. There is really no significant difference between borrowers and nonborrowers from this early 1980 period on. So, they haven't been able to make up for higher interest costs through greater sales, relative to nonborrowers.

As far as reported price increases, what they report is what their average price increase has been during the last quarter. That certainly has not widened over nonborrowers—if anything it's narrowed—but that only reflects the very competitive nature of the industries that most of these businesses are in. They aren't able to pass all of this on. That has resulted in lower earnings.

Now, the question is, what does this mean to the small business community, what does it mean to our national economy? I would like to refer you to charts 5 and 6 on the last page of the testimony. Two things stand out on these charts. The first is that borrowers, who, as I have said earlier, have greater capital expenditures than nonborrowers, that difference over the nonborrowers has narrowed and not surprisingly. Interest rates are higher. They are spending less on capital expenditures.

On chart 6, looking at net employment gain, people, the percent, who said they added employees versus the percent who said they decreased the number of people they employ. What has happened is that borrowers, who had always added more employees, versus nonborrowers, have had to decrease their employment gains relative to nonborrowers.

In fact, we have had comments on the surveys that have suggested some businesses have had to let individuals go so they could make their interest payments. While those are some individual comments, that is also reflected in the sample of about 1,000 borrowers out of a 2,000-member sample.

What I consider the implications of these data for economic expansion are that if we expect to have an economic expansion with the current high interest rates, it is going to be very limited relative to the expansion we experienced in the midseventies. I think you have probably had testimony where, during this time, small businesses added—were probably the greatest generators of new employment, innovators and, if they can't borrow as much, if they are hiring less, in fact, having net employment losses, they aren't going to participate in this expansion.

Given the small business importance in the national economy, that expansion just couldn't be as great as it was in the midseventies.

As a summary, I would like to say that one thing that we see from the data is that the penetration of the money market funds, especially into the rural areas, as smaller banks raise their cost for funds and, therefore, narrow the differential between loans at smaller banks or rural areas versus larger banks in metropolitan areas, and that higher interest rates, in fact, have had a rather debilitating effect on small business to generate new employment and to generate capital expenditures.

Thank you.

[Mr. Scott's prepared statement with attachments follows:]

PREPARED STATEMENT OF JONATHAN A. SCOTT, ASSISTANT PROFESSOR OF FINANCE, SOUTHERN METHODIST UNIVERSITY, AND CONSULTANT, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Chairman, the ability of small business to obtain the required financing needs from the commercial banking system is an important economic issue. Small business relies almost exclusively on the commercial banking system for its short-term credit needs (see Table 1) and has virtually no access to alternative sources available to large businesses, such as the commercial paper market. With the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, the competitive environment in which banks operate has changed and possibly their ability to satisfy the borrowing needs of small business. The purpose of this testimony is to provide background information on the borrowing characteristics of the small business community, the ability of the commercial banking system to satisfy small business credit needs, and the impact of high interest rates on small business' ability to generate employment opportunities and expand their operations.

Data from two surveys of the membership of the National Federation of Independent Business (550,000 firms) are used in this statement. The first survey is the Quarterly Economic Report which asks about planned and actual inventory, capital expenditure, employment, sales, price and borrowing changes. Approximately 7000 questionnaires are sent out each quarter and the number of responses ranges from 1900 to 2200. The other survey, Credit, Banks and

Small Business, was conducted in April 1980, and over 4400 members responded to a mailing of over 14,000 questionnaires. In this survey members were asked about terms on the most recent loan, their ability to obtain credit, and their ranking of desired attributes of banking services with a rating of their bank on each of these attributes.

The principal conclusions of this statement are:

1. The proportion of small businesses borrowing on a regular basis ranges from 40 to 50 percent, depending upon business conditions. In dollar terms aggregate small business loan demand has varied between $28 and $35 billion dollars.
2. Small businesses have not had significant problems obtaining credit. Most of the reported availability related problems were related to borrowers' misperception of their own riskiness.
3. Small businesses have, on average, been paying within 2 percent of prime rate. Businesses located in cities, the Pacific and New England regions, and statewide branching states have been paying higher rates, although these differentials have been narrowing.
4. The characteristics of banks most desired by small business are a knowledge of their business and a reliable source of credit. Banks performed best on accessibility and service offerings.
5. The cumulative effect of high interest rates has caused borrowing small businesses to i) reduce their capital expenditures relative to non-borrowers and ii) reduce their employment gains below non-borrowers.

The remainder of this statement discusses the data underlying each of the above conclusions.

Characteristics of Borrowing Firms

The percent of firms borrowing at least once every three months has varied from a low of 38 percent in the fourth quarters of 1974 and 1977 to a high of 51 percent in the fourth quarter of 1978 (see Table 2a). Small business borrowing needs fell dramatically during the brief 1980 recession (50 to 41 percent) as did overall borrowing demand.[1] The percent borrowing has also fallen five percentage points from the fourth quarter of 1980 to the first quarter of 1982.

The median loan size for short-term loans originated during the fourth quarter of 1979, and the first quarter of 1980 was slightly over $20,000. Assuming that the NFIB membership is a representative sample of the 3.5 million employing small businesses in the economy, aggregate demand for short-term borrowing from small business has ranged from over $35 billion during the first quarter of 1980 to about $28 billion currently. Using 43 percent as the average borrowing percentage during 1981, small business constituted almost 25 percent of the total short-term borrowing demand.[2]

Agriculture, wholesale, construction and manufacturing industries have had the highest percentage of borrowers, followed by construction, retail, and finance with the service and professional firms showing the lowest percentage of borrowers (Table 2b). The decline in borrowing from the early 1980 highs to the present has been primarily due to adjustments in borrowing in the construction, manufacturing, wholesale, retail, and finance industries; the

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[1]Business short-term borrowing fell from $91.4 billion in 1979 to $55.0 billion in 1980 (Salomon Brothers, 1982 Prospects for Financial Markets).

[2]Salomon Brothers has estimated total short-term borrowing demand for 1981 to be $127.1 billion (1982 Prospects for Financial Markets).

decline from the most recent peak in the second quarter of 1981 is attributable to only the construction, manufacturing and retail industries.

Small business borrowers employ more individuals, have greater sales, and have larger capital expenditures than non-borrowers (see Table 3). Borrowers, on average, have $500,000 greater annual sales, employ 5 more individuals, and make $7500 more per quarter in capital expenditures. Small business borrowers also are growing more rapidly than non-borrowers. In April 1980 over 60 percent of the borrowers reported that they were growing or rapidly growing as compared to only 45 percent of the non-borrowers.

Credit Availability

Small business has not had a significant problem finding credit to satisfy their borrowing needs. In the April 1980 survey over 80 percent of the borrowing respondents reported that all or most of their credit needs were met. The April 1980 survey also asked: 1) "if current availability (not the cost) of business credit has caused you to cancel, postpone, or scale down plans to expand, modernize, or renovate [their] business" and 2) "if the current interest rates have caused you to cancel, postpone, or scale down plans to expand, modernize, or renovate [their] business." Over 55 percent of the small businesses reported some retrenchment in expansion plans due to availability problems in early 1980, although the percentage for all loan attempts was slightly over 45 percent (see Table 4).

The data in Table 4 may be somewhat misleading regarding the extent of credit rationing in the small business community. Almost 50 percent of those who reported reducing, postponing, or canceling expansion plans for availability problems reported the same for current interest rates (see Table 5). This high correlation is not surprising. If cost rations a borrower out of the market, credit may be viewed as harder to get. The data in Table 5 thus

suggest that a very low percentage of the small business community reported true credit rationing problems, i.e., reported no problems with interest rates but did cancel, postpone, or reduce plans due to availability problems. Table 6 presents a time series behavior of the data in Table 5 which have been reclassified into five groups: 1) those who reported availability problems but no interest rate problems (3 percent); 2) those who reported interest rate problems but no availability problems (21 percent); 3) those who reported neither availability or interest rate problems (29 percent); 4) those who reported both interest rate and availability problems (43 percent); and 5) no answer (4 percent). Relative to the overall distribution and the "interest rate only" and "neither" categories, availability problems were more frequently reported in the first quarter of 1980, a period of record high interest rates and a period that has been characterized as one of tight money.

The breakdown of the data in Table 6 is useful for analyzing satisfaction with loan terms (see Table 7). Most small businesses had at least 90 percent of their original loan requested granted; over 75 percent found their final loan terms to be satisfactory or very satisfactory. Those borrowers reporting "availability problems only" had a significantly lower percentage of the initial loan request granted and less frequently reported final loan terms as very satisfactory. Not surprisingly, those reporting "availability problems only" most frequently reported the amount of the loan as the reason for dissatisfaction while all others reported the interest rate charged most frequently. For other loan terms such as maturity and collateral, however, the distribution of responses from those reporting "availability problems only" did not appear to differ significantly from the other groups.

The data have been analyzed statistically to determine if any significant firm specific or bank structure characteristics exist for distinguishing those

borrowers reporting availability problems and those borrowers who have not. None of the bank structure characteristics (degree of branching, bank size, number of banks in the community) were significant. Risk was the significant factor distinguishing borrowers who reported availability problems (higher risk) and those who did not (lower risk). Borrowers who had collateralized loans or who had been in business for a few years or whose growth was declining had a significantly greater chance of having availability problems. Reported availability problems thus have little relationship with the potential borrower being unable to obtain credit at any price and appear to result more from a divergence of opinion between the bank and the borrower regarding the borrower's risk.

Cost of Credit

Small businesses have, on average, been paying close to the prime rate for their short-term funds (see Table 8). Up until the second quarter of 1981 the average rate paid was at or below the prime rate. Since then the average rate has been from one to two percentage points above the prime. The dispersion in the distribution of interest rates paid has narrowed substantially between the fourth quarter of 1979 and the first quarter of 1982. The data suggest that "cheap" sources of funds available early in 1980 (e.g., loans against the cash value of a life insurance policy) have virtually disappeared.

Interest rates paid on short term have shown significant variation by size of the bank market, region of the country and branching status (see Table 9). Businesses in rural markets pay lower rates than businesses in metropolitan markets primarily due to a difference in wages, rents, and other overhead costs. Businesses located in New England and the West Coast paid higher rates than average, while businesses in the South paid lower rates than av rage. These differences are partially attributable to regional variations in wages,

rents and other overhead costs. Businesses located in statewide branching states have paid higher rates than those in limited or unit banking states. This branching effect is difficult to interpret because regional classification and branching status are highly correlated.

The size of these market, regional, and branching interest rate differentials has been declining since early in 1980. The urban-rural spread, over three percent during the fourth quarter of 1980, is down to one-half of a percent; the largest regional difference is down to 1.3 percent from 2.5 percent in early 1980; and the largest branching difference is down to .6 percent from 1.2 percent in early 1980. Whether or not these narrowing spreads are due to degregulation is difficult to conclude at this time.

Ranking of Bank Service to Small Business

Small business borrowers ranked "knows you and your business" most frequently (72 percent) as a "very important" characteristic in conducting their banking business (see Table 10). "Reliable source of credit" was next most frequently reported (58 percent) as "very important" followed by "offers the 'cheapest money' available" (49 percent). When both "very important" and "important" rankings were combined, the characteristics clustered into three groups. The highest ranking group included "knows you and your business" and "reliable source of credit;" the next highest ranking group included "offers the 'cheapest money' available," "one person always handles your credit needs," "easy to get to," "knows your financial needs," and "offers a wide range of banking services;" the least important group included "provides helpful business conditions," "knows your industry," and "comes to you with ideas for improving bank service." These rankings suggest that the non-price aspect of lending to small business is a very important part of the lending relationship.

The respondents also reported their ratings of how well the banks performed on these characteristics (see Table 11). These ratings also clustered into several groups when combining the "good" and "above average" ratings. The group with the highest proportion of positive responses included "easy to get to," "offers a wide range of banking services," "one person always handles your credit needs," "reliable source of credit," and "knows you and your business" in that order. The group with the next highest proportion of positive responses included "offers the 'cheapest money' available," "knows your industry," and "knows your financial needs." It is interesting to note that banks were rated highest on items that were not directly related to personal contact with the borrower, i.e., location and service offerings.

The actual ratings of the top ranking group of desired characteristics ("knows you and your business" and "reliable source of credit") showed some systematic variation with the size of the bank market, size of the bank, and degree of branching. Rural banks were rated higher than city banks, smaller banks higher than larger banks, and unit and limited branching banks higher than statewide branching banks. These correlations corroborate a generally held feeling about the strong loyalty between banks and their customers in a rural or small town area (which most often have smaller banks and are located in unit and limited branching states).

Longer-Term Implication of High Interest Rates

The impact of higher financing costs as a borrower's most important problem has generally moved closely with the borrower's perception of credit being harder to get (which in turn has been closely related to the level of interest rates (see Chart 1)). Since about mid-1980, however, the correlation between tween availability of financing costs as the borrower's most important problem has been broken. The break is due to the cumulative impact of higher interest

rates on smaller business' ability to generate sufficient cash flow for their intended expansion plans.

Up until early 1979 the difference in the net earnings change (percent reporting higher less the percent reporting lower) between borrowers and non-borrowers averaged close to zero (see Chart 2). Since mid-1979, however, non-borrowers have reported a consistently higher net earnings change than borrowers.[3] This deteriorating earnings position is due to 1) borrowers not generating sufficient sales increases to cover increased borrowing costs (see Chart 3) and 2) the inability of borrowers to pass all of the higher interest cost on in the form of higher prices (see Chart 4).

The cumulative impact of high interest rates on borrowing small businesses' earnings has caused them to reduce capital expenditures relative to non-borrowers. The difference between the net percent reporting capital expenditures (percent yes less percent no) for borrowers and non-borrowers has fallen from an average of 18 percent in late 1979 to an average of 7 percent from 1980 to the present (see Chart 5). Higher interest rates have also caused borrowing small businesses to reduce their hiring relative to non-borrowing small businesses. Borrowing small businesses consistently reported greater net employment gains (percent adding less percent decreasing) over non-borrowers up until mid-1979 (see Chart 6). Since that time non-borrowers have reported higher net gains (actually lower net losses) than borrowing firms.[4]

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[3]The average difference between borrower and non-borrower net earnings from October 1973 to January 1979 was -1.6 percent; from July 1979 to the present this difference has widened to -9.3 percent.

[4]The average difference between borrower and non-borrower net employment gain from October 1976 to October 1979 was 3.3 percent; from January 1980 to the present this difference has fallen to -3.7 percent.

The data graphed in Charts 1 to 6 suggest that an economic expansion commensurate with the mid- to late-1970's expansion cannot occur unless interest rates fall. During the mid-1970's small business was the major contributor to employment gains and innovation. The continued high level of interest rates has brought small business employment gains to a halt and has substantially reduced the capital expenditures necessary to expand their businesses.

TABLE 1

Sources of Small Business Loans

Source	Percent Reporting		
	SHORT-TERM	MEDIUM-TERM	LONG-TERM
Bank	90%	82%	69%
Private Individual	4	5	9
Government	1	1	4
Finance Company	1	4	2
Insurance Company	1	1	2
Factor	*	*	*
Co-op	1	1	1
Saving and Loan	1	1	7
Other	1	4	4

*Less than .5 percent.

Source: Credit, Banks, and Small Business (April 1980), National Federation of Independent Business.

TABLE 2a

Borrowing Behavior of All Firms

Year/Quarter		Percent[a] Borrowing	Year/Quarter		Percent[a] Borrowing	Year/Quarter		Percent[a] Borrowing
1973	III	40	1977	I	40	1980	I	50
	IV	39		II	41		II	41
				III	40		III	43
1974	I	41		IV	38		IV	45
	II	45						
	III	42	1978	I	47	1981	I	44
	IV	38		II	47		II	45
				III	46		III	43
1975	I	42		IV	51		IV	40
	II	39						
	III	39	1979	I	n.a.	1982	I	40
	IV	39		II	46			
				III	48			
1976	I	39		IV	46			
	II	39						
	III	40						
	IV	40						

TABLE 2b

Borrowing Behavior by Industry Classification

	Percent Reporting[a]					
Industry	73III 74II	74III 77IV	78I 80I	80II 80III	80IV 81III	81IV 82I
Construction	54%	49%	56%	47%	52%	47%
Manufacturing	39	39	49	41	44	41
Transportation	52	44	57	46	50	50
Wholesale	54	51	59	53	55	53
Retail	39	38	46	40	43	36
Agriculture	54	58	61	61	61	63
Finance	42	39	48	45	43	41
Service	29	24	31	29	30	28
Professional	30	29	35	33	34	35
All	41	40	48	42	44	40

[a]Percent of all firms, including those not borrowing regularly (at least every three months).

Source: Quarterly Economic Report (October 1973 to April 1982), National Federation of Independent Business.

TABLE 3

Borrower/Non-borrower Charateristics

	Annual Sales (000) Percent Reporting							
	Under $50	$50 to $100	$100 to $200	$200 to $350	$350 to $800	$800 to $1500	$1500 to $3000	Over $3000
Borrower	6%	9%	13%	12%	20%	14%	10%	15%
Non-borrower	11	14	16	15	18	10	7	6

	Employment (fulltime) Percent Reporting							
	1	2	3-5	6-9	10-14	15-19	20-39	40+
Borrower	5	7	24	19	13	8	12	12
Non-borrower	9	12	30	18	10	6	8	6

	Capital Expenditures (000) Percent Reporting					
	Under $1	$1-5	$5-10	$10-20	$20-50	$50+
Borrower	3	10	10	10	11	15
Non-borrower	6	12	11	9	7	8

	Business Activity Description Percent Reporting				
	Rapidly Growing	Growing	Steady	Declining	Too New
Borrower	13	51	24	10	2
Non-borrower	7	39	32	8	3

Source: Quarterly Economic Report, (October 1973 to January 1982), Credit, Banks, and Small Business (April 1980), National Federation of Independent Business.

TABLE 4

Reported Credit Availability Problems and

Small Business Expansion Plans

Impact of Availability Problems	Number of Cases	Last Time Loan Attempt Was Made Percent Reporting							
		Total	1Q 1980	4Q 1979	3Q 1979	2Q 1979	1Q 1979	1978	Before 1978
Plans Cancelled	316	11%	13%	11%	13%	14%	11%	12%	8%
Plans Postponed	523	19	22	23	19	19	16	18	13
Plans Reduced	433	16	21	19	17	16	13	12	8
No Effect	1218	44	35	38	41	41	52	48	59
Undecided	186	7	6	7	7	7	6	7	8
No Answer	83	3	3	2	3	3	2	3	4

TABLE 5

Impact of Credit Availability Versus Interest Rates

on Small Business Expansion Plans

Impact of Availability Problems	Number of Cases	Impact of Interest Rates Percent Reporting					
		Plans Cancelled	Plans Postponed	Plans Reduced	No Effect	Un-decided	No Answer
Plans Cancelled	316	47%	6%	2%	1%	2%	7%
Plans Postponed	523	12	51	8	2	6	15
Plans Reduced	433	11	9	50	4	7	4
No Effect	1218	20	24	34	89	34	28
Undecided	186	6	5	5	3	48	2
No Answer	83	4	3	1	1	3	44

Source: Credit, Banks, and Small Business (April 1980), National Federation of Independent Business

TABLE 6

Availability/Interest Rate Impact on Retrenchment

of Small Business Expansion Plans Over Time

Date of Last Loan Attempt	All	Availability/Interest Rate Impact Percent Reporting				
		Availability Only	Interest Rate Only	Neither	Both	No Answer
1Q 1980	28%	34%	28%	20%	35%	21%
4Q 1979	15	10	16	11	17	12
3Q 1979	10	12	8	10	10	11
2Q 1979	8	10	9	7	9	8
1Q 1979	6	2	8	6	6	3
1978	12	12	12	13	11	11
Before 1978	21	20	19	33	12	34

Source: Credit, Banks, and Small Business (April 1980), National Federation of Independent Business

TABLE 7

Loan Terms and Availability/Interest Rate Impact on

Retrenchment of Small Business Expansion Plans

Percent of Original Loan Request Granted	Number of Cases	Availability/Interest Rate Impact Percent Reporting				
		Total	Availability Only	Interest Rate Only	Neither	Both
90-100	2450	85%	71%	93%	91%	81%
65-89	116	4	4	2	3	6
50-64	81	3	9	*	1	4
Under 50	97	3	12	*	1	6
No Answer	114	4	4	4	4	3
Final Loan Terms Were						
Very Satisfactory	74	38%	20%	45%	56%	27%
Satisfactory	1094	38	49	37	34	40
Not Too Good	1095	17	24	14	8	24
Unsatisfactory	492	4	5	2	*	6
No Answer	103	3	2	2	2	3
Reasons for Dissatisfaction[1]						
Interest Rate		39%	23%	59%	42%	37%
Amount		13	26	3	12	14
Maturity		11	11	8	8	12
Collateral		15	9	14	11	16
Other		22	31	16	27	21

*Less than .5 percent.

[1]For those reporting that the final loan terms were "Not Too Good" or "Unsatisfactory."

Source: Credit, Banks, and Small Business (April 1980), National Federation of Independent Business

TABLE 8

Interest Rates Paid on Short-term Loans

Interest Rate Paid	Percentage Reporting							
	79:4	80:1	80:4	81:1	81:2	81:3	81:4	82:1
under 10%	2%	2%	1%	1%	1%	*	*	*
10 to 12.9%	22	8	5	2	1	1	1	1
13 to 15.9%	45	25	22	14	8	4	9	5
16 to 18.9%	23	35	33	54	36	33	63	79
19 to 20.9%	6	22	17	20	29	33	18	11
21 or more	2	8	22	9	25	29	9	4
Number of Cases	305	761	1019	1012	978	942	948	946
Average Rate	14.6	16.4	18.0	17.7	19.0	19.3	17.9	17.8
Prime rate at end of quarter	15.3	19.8	20.2	17.2	20.4	18.5	15.8	16.5

*Less than .5 percent.

Source: Quarterly Economic Report (January 1981 to April 1982), Credit, Banks, and Small Business, (April 1980), National Federation of Independent Business.

TABLE 9

Average Interest Rate Paid

By Selected Characteristics

	79IV-80I	80IV	81IV
Industry			
Construction	16.3%	18.0%	18.0%
Manufacturing	17.0	18.7	18.2
Wholesale	17.2	19.0	17.6
Retail	16.0	17.9	18.0
Financial	15.2	17.4	17.7
Services	15.3	17.7	18.0
Market			
Rural	15.4	15.8	17.6
Suburban	17.0	17.9	18.0
Metropolitan	16.7	19.2	18.1
Region			
New England	17.7	19.1	17.6
Mid-Atlantic	16.4	17.8	17.5
East North Central	15.8	17.9	17.8
West North Central	15.5	17.2	17.4
South Atlantic	15.2	17.5	17.8
East South Central	15.8	18.0	17.6
West South Central	16.1	17.7	18.1
Mountain	16.4	18.3	18.2
Pacific	17.3	19.0	18.7
Branching Status			
Unit	16.0	17.6	17.8
Limited	15.7	17.8	17.6
Statewide	16.9	18.6	18.2

Source: Quarterly Economic Report (January 1981 to April 1982), Credit, Banks, and Small Business (April 1980), National Federation of Independent Business

TABLE 10

Small Business Rankings of Bank Characteristics

Important in Their Banking Relationship

Characteristic	Percent Reporting			
	Very Important	Important	Not Very Important	Not Important
Knows you and your business	72%	20%	3%	2%
Provides helpful business suggestions	24	32	24	12
Offers the "cheapest money" available	49	31	10	3
One person always handles your credit needs	44	37	10	3
Easy to get to	40	38	13	4
Reliable source of credit	58	31	3	1
Knows your industry	29	33	22	7
Comes to you with ideas for improving bank service to your firm	18	35	27	11
Knows your financial needs	35	41	11	5
Offers a wide range of banking services	33	40	15	5

Source: Credit, Banks, and Small Business (April 1980), National Federation of Independent Business.

TABLE 11

Rankings of Bank Performance

on Characteristics Ranked

Very Important or Important

Characteristic	Percent Reporting			
	Good	Above Average	Below Average	Not Good
Knows you and your business	51%	31%	11%	4%
Provides helpful business suggestions	27	30	28	13
Offers the "cheapest money" available	30	38	18	11
One person always handles your credit needs	54	31	8	5
Easy to get to	59	30	6	2
Reliable source of credit	52	33	9	4
Knows your industry	31	33	22	10
Comes to you with ideas for improving bank service to your firm	19	27	30	22
Knows your financial needs	33	36	19	9
Offers a wide range of banking services	50	36	8	3

Source: Credit, Banks, and Small Business (April 1980), National Federation of Independent Business.

CHART 1

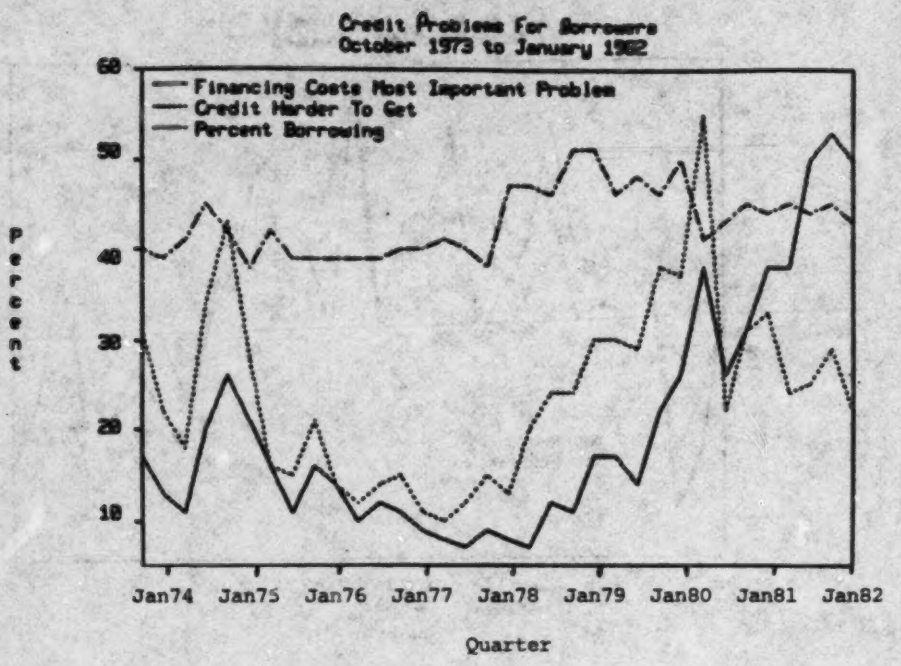


CHART 2

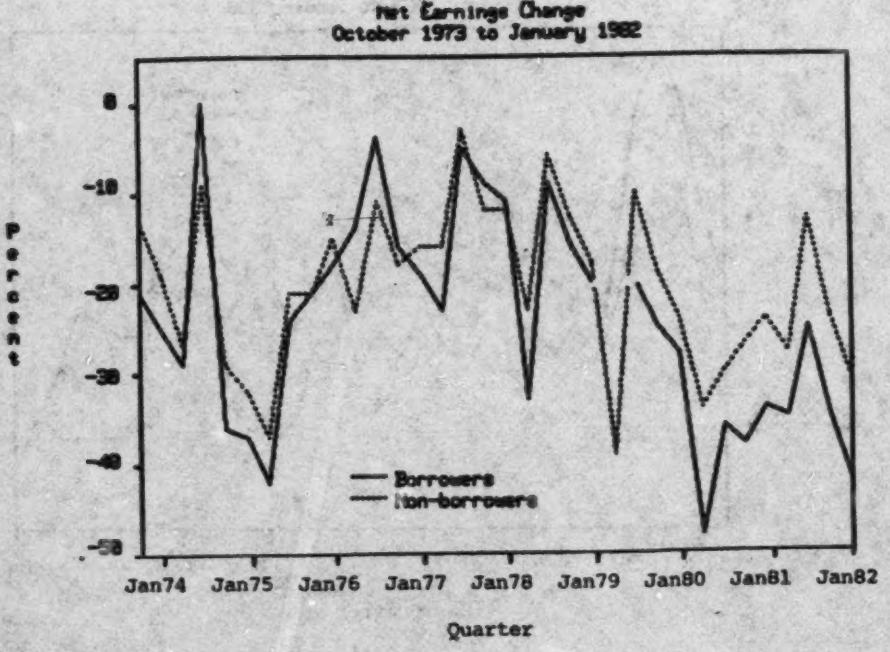


CHART 3

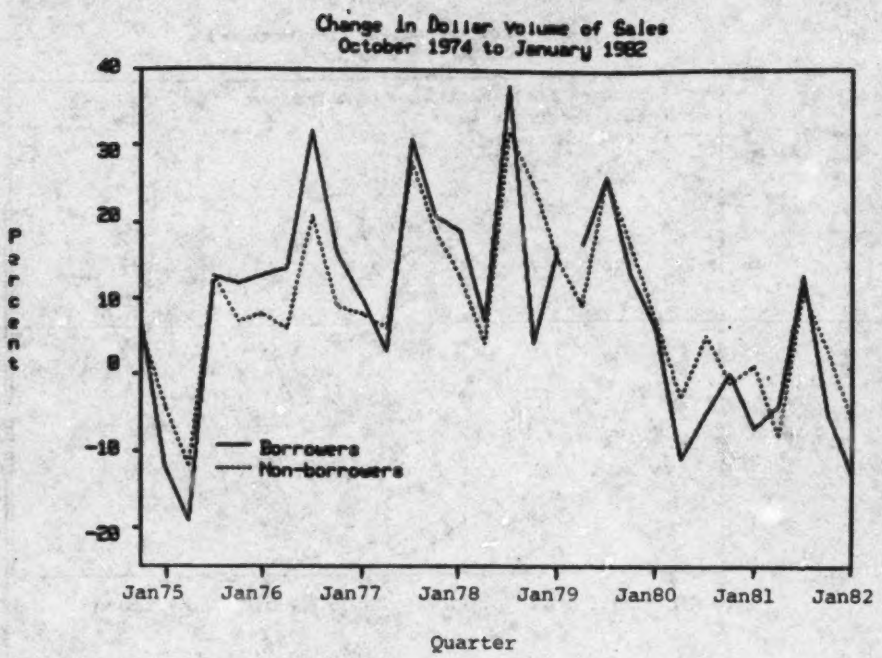


CHART 4

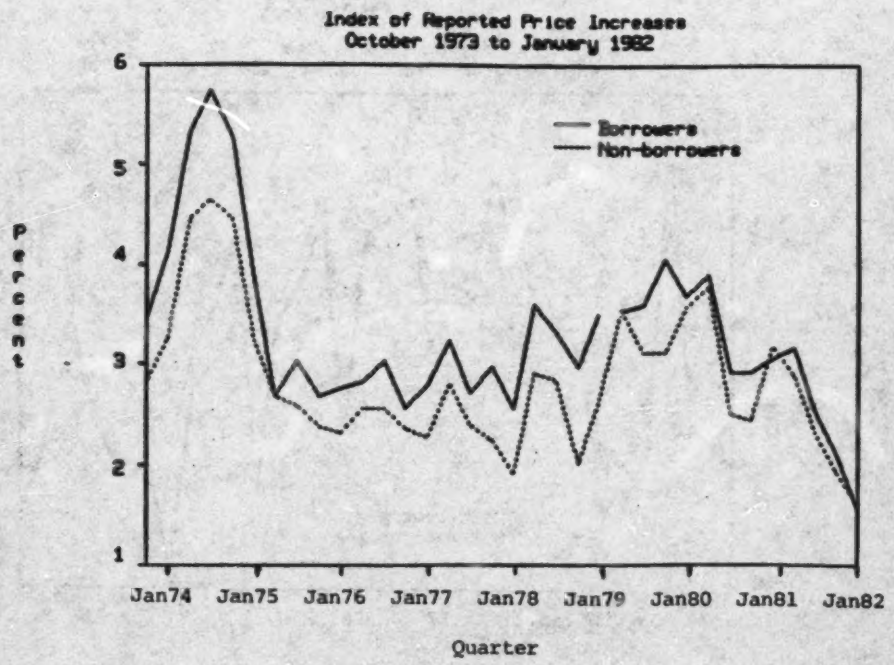


CHART 5

Net Capital Expenditures
July 1979 to January 1982

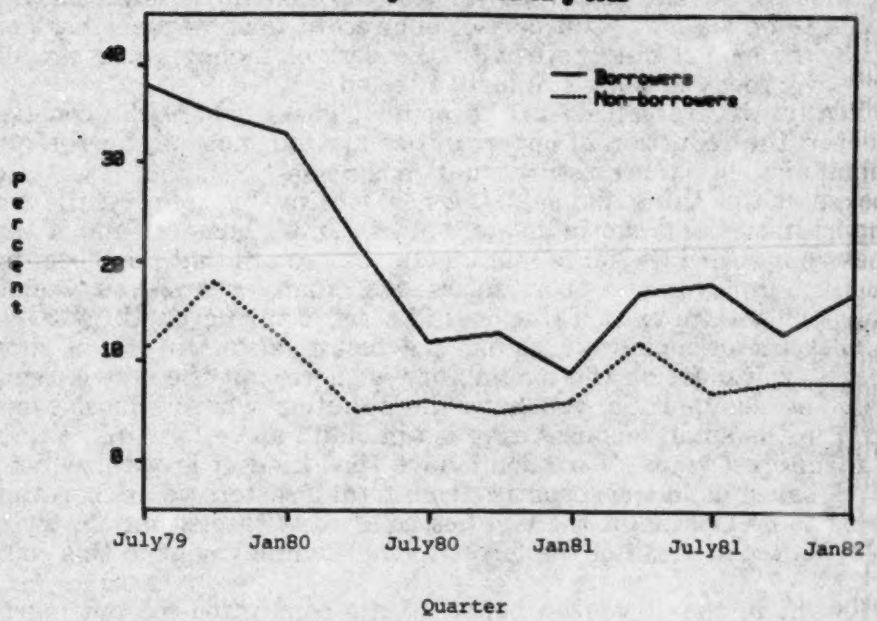
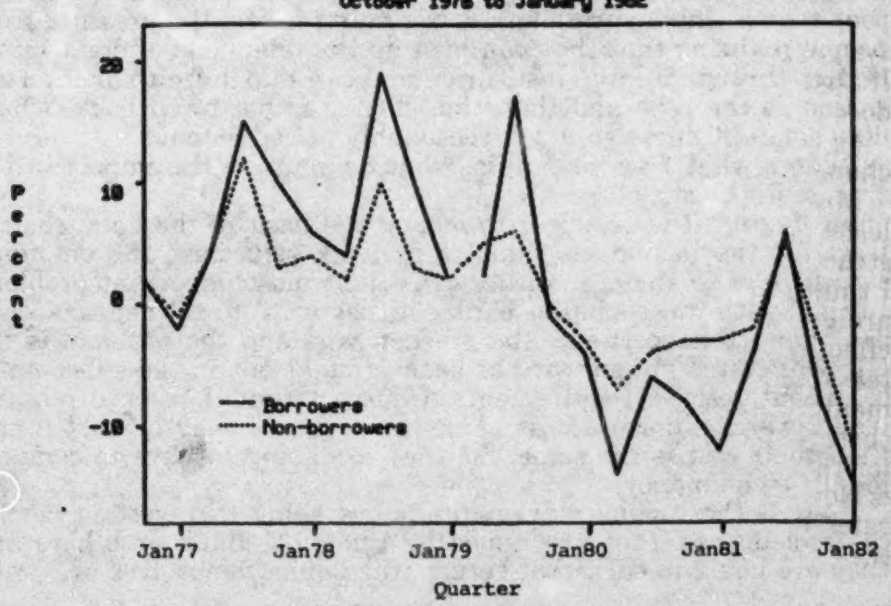


CHART 6

Net Employment Gain
October 1976 to January 1982



Mr. NOWAK. Thank you very much for your testimony. The charts are a vivid explanation of what really has gone on over the last 2 years. We hear individual stories that I think generally are verified by the statistics that you put together in these tables. It is going to be a very useful part of our record to show what has generally happened out there with the cost of money going up and how everybody is being similarly affected.

Really, we are getting to the point, I guess, where the constriction, or the reduction of opportunities are felt, not only in the new companies, but the existing small businesses. You know, we have looked at this thing and said, the new jobs in this country, the new opportunities and the innovators are in small business and if that goes, along with the large manufacturing sectors that have been reducing employment opportunities over many years, you wonder how long we can exist if this doesn't start to turn around.

The cost of moneys, I think is a factor, also. On one of those charts, you mention the availability is there, but the cost is really reducing demand. So, you have the situation where almost everybody in the small business area is unable to move forward at these high interest rates. If we don't have that kind of growth, which I think saved us in the seventies from total disaster, we are certainly going to be looking at the eighties as a worst case situation, trying to bring together all of the forces for new employment in this country.

I want to thank you on behalf of the committee for putting together the testimony, and vividly bringing that to our attention.

It would seem, too, that even the smaller banks in the rural communities are now finding that the average cost of money is starting to slow up. I wonder if you have any thoughts on the structure's change, because, you know, your statistics would seem to indicate that even a small, rural bank is beginning to feel the pressure from people realizing that they can pick up the telephone and get into a system through a large institution and can maximize their interest. If that is the case and then that money is borrowed back, where does small business go to get reasonably priced money?

I guess what I am asking is, what do you feel the impact of the change in the structure is?

Mr. SCOTT. It is not clear to me, on the basis of the data, that at least for the businesses sampled, a bank structure, the changing structure of financial institutions is their most important problem. I think, with these smaller banks, if they want to get deposits, they are going to have to pay the market rate, and the problem is the effect of cost. I am sure it has been brought out in the subcommittee about reserve requirements. I suspect that if reserve requirements were uniform across banks as well as money market funds, then their cost is the same. So, they are going to have to compete for the same money.

Now, if the money market funds are going to invest in certificates of deposit that are issued by Chemical Bank or others and they are going to earn that return, the banks themselves are going

to be able to make small business loans at a higher price than their cost of funds and that should be more profitable.

So, I guess the question—there are two points. One is that—one thing that I have a strong opinion about is that having uniform reserve requirements so that the effective rate for all institutions, whether it is Sears or Merrill Lynch or a small community bank or Chemical Bank, their effective cost is the same. Then profit can be made through lending to small businesses.

The second point that I would like to make has to do with the overall level of rates. I think that is what we have talked about. You know, what can we do to lower interest rates? Somebody who is thinking about starting a small business now has to incur that risk of uncertain return. They compare that to investing in Treasury bills that potentially yields maybe a 6- or 7-percent real rate of return, versus an uncertain rate of return that they have not experienced at least over the last few years, has not been that high. So, there is disincentive with very high real rates to start a business.

I guess being a college professor, you always have an opinion on something, but, at least, with respect to the high level of interest rates, my feelings are this. I have talked with several pension fund managers and life insurance company managers. They are very reluctant to buy long-term securities, and this is due in part to the projected deficit, not so much the current, but the projected deficit and, in particular, the impact of the unfunded social security liabilities.

Being pension funds and life insurance companies, they understand these things about these unfunded liabilities. The comments I have had from several individuals is that given the size of this projected liability in the future, that there are only two ways to meet it. One is to print more money, which would result in more inflation, or the other is to borrow in competition with businesses for scarce household savings. Instead of maybe borrowing 25 percent of the available savings, the Government would be borrowing 50 percent. So, either way, you end up with projected higher rates in the future.

Why haven't short-term rates fallen? Few businesses are willing to borrow long term, locking in this 14 percent or 15 percent. Most of them are borrowing short-term and the banking officers that I have talked to suggested that much of the long-term borrowing that has been done by medium, maybe larger size businesses is now really short term and banks get their money through short-term markets. So, they are issuing certificates of deposit. The holding companies are issuing commercial paper and that keeps the pressure on short-term rates. That keeps them up higher.

It is my feeling, and I can't prove it, that the key to the problem may be in part the current deficit, but I suspect also has to do with the large unfunded liabilities with social security. Of course, that is a very difficult political issue to grapple with.

Mr. NOWAK. Besides the general discussion of interstate banking and deregulation and changes in Glass-Steagall, are there any other strictly banking issue problems that small business people you have come in contact with have stated that we haven't focused on in the hearings?

Mr. SCOTT. Let me have Denny answer that with respect to some mandates.

Mr. DENNIS. The only thing I think—there are two points that have been brought up that I am not sure that your hearing has covered or not. One of them is some anecdotal information, which we received from a couple of small businessmen and one professor, and it had to do with bank examiners and the way they rate or judge new business loans. These individuals allege—whether or not it is true, I don't know—but they alleged that when a bank examiner comes in and takes a look at a new business loan, it is automatically classified as a risky or bad loan.

On the other hand, if that loan was given to an individual, not as a business loan, not as a commercial loan, but as a personal loan, that loan would not be considered a bad or risky loan, the idea or the net effect being that it is more difficult to get a new business loan, simply because banks quite naturally don't want to have a large portion of their loans classified as being risky or bad.

That is an issue that I would ask you to explore anyway. The second one, of course, is this entire new area of potential competition for various types of banking activity. In other words, expanding the definition of really what a commercial activity is and, for example, there has been some suggestion that banks might quite legitimately begin to get into the data processing business. They might legitimately get into the real estate business, things of that nature.

Of course, our members are against that. These are just two issues and I don't know to what extent you have anticipated covering them, but I would urge you to look at these two.

Mr. NOWAK. I think we should look at capital in general and where it is going. You know, this merger syndrome is probably going to be expanding. It is disturbing whether you look at little real estate companies, who now are having particular problems, or the growth of nationwide major organizations, such as Merrill Lynch and Caldwell. They are saying Caldwell is going to be bought up and there seems to be a spreading of that whole syndrome. Independent insurance people—the brokers and so forth—are concerned about the bank selling.

I think you made a very good point, Mr. Scott, when you talked about what direction do we go in. Do we totally deregulate the banks so they can compete with the money market funds? That is the reverse of what has really been the case. Now, that that is out there, you only have one or two choices. You have to make the banks hold or you have to hold back through some mechanism.

You suggested a reserve requirement to make competition equal. The Treasury Secretary has emphatically said that he can't put any restrictions on money market funds, especially any type of accounts that are issued under, call it as a CMA, for some reason. This whole process has really changed the structure.

Mr. Marriott is very concerned about this and expressed the thought here, how do we get these rates down. Does it take holding back of all the so-called competition? Our former Administrator of SBA says that we should do something. The financial services world isn't the same as producing widgets and we have to have some cap on that if we are ever going to bring this process back to

where it can generate dollars for the small business community and the housing community and get this thing working again.

Could you provide the committee with any specific information as to why you believe the reserve requirement may be a better way to go than opening up the free market financial system and the effect on those mergers and so forth? Do you have any specifics on that that you could give us?

Mr. SCOTT. The primary reason for personally advocating uniform reserve requirements is that it makes the effective cost the same for the banks as well as the money market funds. So, they are competing at the same level.

I guess my major point would be that for small business, the biggest problem illustrated in the charts and testimony is the high level of interest rates. It is not clear to me that usury ceilings, in particular, would be an effective way of lowering this cost, even if there was a usury ceiling on Government debt. It would either be bought at a discount or people would lend their money overseas. We would truly have an international financial market and we tend to see with the innovation in deregulation more of a uniform national market now.

The data suggest that the biggest problem is the high level of interest rates and, perhaps in the survey that is being completed now, we will have more information about this change in the bank structure and what is happening to this rural or the large versus small difference. That is really the only input I can provide for you on that question.

Mr. NOWAK. Interest rates and the leveraging of money has provided tremendous opportunities in this country. If you look to the forties, fifties, and sixties, the guy that grew, the guy that expanded did not make money and reinvest money. He made money and borrowed and leveraged and then he grew because he had that ability to leverage.

We have thrown out reg Q or at least raised it substantially now and pretty soon it is going to be something that is gone forever. I am wondering if this doesn't change the opportunities that are available in the small business community more than anything else that we have ever done in this country. I don't remember in the forties, fifties, and sixties a lot of small businesses saying they were inhibited and they couldn't grow and, this structure was awful because they could only get 5¼ percent from a bank. We are seeing the reverse of this in the structure and it is a brand new phenomenon really and nobody has spoken to it or written anything that sorts out the impact. I have seen articles that said inflation was public enemy No. 1 and now, you have got economists starting to question what the other side of that coin is.

If we get backed to zero-based inflation, don't we create other restrictive problems, especially for the small business community and the average American to purchase a home and so forth in this country and are we willing to do that and should we be willing to do that? In other words, are we going to have more opportunities in this country in the next 10 years than we had in the forties, fifties, and sixties?

Mr. SCOTT. I would argue, as I did earlier, that at the current high rates, unequivocally no. There won't be as many opportuni-

ties. Most of NFIB's membership are in very competitive industries. The charts have suggested that they weren't able to pass on to borrowers those high borrowing costs. In fact, with lower inflation rates, that means it is a higher real cost of funds, and that is reflected in lower earnings. I think that is going to inhibit their ability to expand.

As you mentioned, during the fifties and early sixties, short-term rates were 2 and 3 percent and inflation was virtually zero, so you have a 2-percent cost of real funds. Now, it looks like, at least at current inflation rates, it is up 6, or 7, or 8 percent and that is a very, very difficult burden for a small business to bear and I think it is reflected in the data.

Mr. NOWAK. Thank you. Richard Centner has a question he would like to ask.

Mr. CENTNER. We keep talking about the price of money, and you mentioned market rates several times, but Mr. Kobelinski's testimony has a line in it on the next to last page, "Only the Government can print money and most importantly set its value." And that suggests there isn't any marketplace, except insofar as the Government wants it to operate. We know that some commodities are overpriced. It is kind of a neat game if you can print the money and then go decide what you are going to charge yourself to borrow it or buy it, in effect. But, isn't that the artificial pricing of a commodity in terms of itself? In other words you say, how much will you give me for an apple and somebody says 25 cents. You say how much will you give me for a dollar. Somebody has to reply in dollars.

So, now you have an underground economy. You have an expectation of inflation. I am wondering if there isn't a way to, rather than say, "gee, the system has put shackles on most people. So let's put shackles on everybody else." Isn't there some way to free up this system? For example, Dan Crane, who sits on this subcommittee, has suggested his Free Market Coinage Act. Let people have unbreakable gold clauses or any other clauses that they want; when they sell their product or services in terms of a commodity, this value will supposedly adjust with the economy. At the end of that period, if the dollar has been devalued, as it can be at any time, you still get full value for your goods and services. I mean, President Nixon just one day devalued the dollar. That meant everything in the banks, everything you had on deposit, everything the banks had in their depositories was suddenly worth less, simply because the Government said it was worth less. The commodities on which those prices were based were not worth less. As a matter of fact, they were automatically worth more against the dollar.

I am suggesting that Mr. Crane's bill might help to allow the marketplace to function and to allow people to make transactions on some other basis than the legal tender laws that we have now, that would allow people to take advantage of opportunities they can't take advantage of now. It would probably also provide conditions for interest rates to be 3 or 4 percent, since that is the profit most people want, to be 3 or 4 percent because they reflect payment in something that can't be artificially and arbitrarily manipulated at the whim of the Government.

I might add, too, a point that Mr. Crane made to me in a conversation. He said money is older than governments and Andrew Jackson carried on quite a fight a little over 100 years ago to preserve the rights of local banks that were serving the local small business community to issue local notes, based on the assets that they held in their own depositories. Those notes were not Federal Reserve notes. They were real assets, gold, silver, jewelry, deeds to real estate in the local area.

And if we go to banking deregulation, while Government controls the issuance of currency and credit, aren't we taking a giant step exactly the opposite direction away from that kind of local flexibility and autonomy into a serious danger of not only having centralized government, but centralized banking that literally puts everybody in the country at the mercy of the people in the major financial markets? Why don't we go to a system where the local market can determine the terms of its own transactions?

Mr. DENNIS. Well, a couple of points very quickly. One is that we don't have an organizational position to operate a gold standard.

Mr. CENTNER. I am not talking about returning to a gold standard. We never had a gold standard in this country because gold standard would say that you tie the dollar to gold. The Government set the price of gold. So, they immediately set the price of the commodity on which they said the standard was based. That is not a true gold standard.

Mr. DENNIS. No.

Mr. CENTNER. At any rate, I am asking why not let people use anything as a standard? They can use salt, celery, or gold, but the point is they determine the commodity on which a transaction is based. For example, I could say that you will pay me 104 ounces of celery for 100 ounces you borrowed. They tie the transaction to a commodity in which they have faith. That is what Mr. Crane wants to do. Of course, he says gold; but, I am saying I don't think gold is the specific point at issue. I think the point at issue is the freedom to set terms of your own transactions if you are going to borrow and lend.

It would seem to me it would draw out a lot of the underground economy and it would allow people to avoid the kind of structural changes that they can't avoid now because there is no way around them. That includes the ones that Mr. Nowak is talking about.

Mr. DENNIS. The first thing I would say is, again, organizationally we don't have a position on that version of return of the gold standard.

My second point would be that I would just have to think about what you said before I could make any intelligent comments.

Mr. CENTNER. I would love to hear what the finance professor says, though.

Mr. SCOTT. I respectfully disagree about the market price. Some say it is every Monday afternoon. There is an auction of Treasury bills and it is through a bidding process, a competitive bidding process. Anybody who wants to submit a bid can. They determine what they are going to require from the Government to maintain a real return plus their purchasing power over a 90-day period.

Mr. CENTNER. But, the point is that as long as there are legal tender laws under which you can't enter into a contract that can't

be broken by appealing to those laws, haven't you subverted the marketplace? Haven't these laws prevented people from drawing up contracts of their own choosing? The fact is, you go and you bid on those notes, because you don't have any alternative. That is the only game in town. I am suggesting there should be another game.

Mr. SCOTT. One, conceivably, if you had at least $100 thousand and possibly more could conceivably lend in the Eurodollar market or lend overseas. I think your point has to deal with unanticipated inflation and what happens to the ability to maintain purchasing power with longer term financial contracts. And what we have seen over the last 3 years is that the market has adapted incredibly well to this unanticipated inflation, primarily at the expense of the borrower, because with this longer term fixed-rate contract, it was the bank who suffered this interest rate risk and now what we have is more floating rate notes and more rates that are tied to some commodities, as you suggested, that will maintain purchasing power.

It is not clear to me that this has been a good impact on the entire financial system because now this interest rate risk has shifted to borrowers. As we see, it is not clear that they can bear this better than the banks.

Mr. CENTNER. Well, I would point out that when the Attorney General wanted to protect his financial holdings, he didn't invest them in money. He invested them in real estate, oil wells, and gas wells. He tied them to something other than flat dollars. Right now, the only people that can do that are people with great amounts of money. They convert their money into something tangible. Why not allow some flexibility in the system so that poor underpaid congressional staff can go out and do the same thing or the people in Buffalo or Salt Lake City, who only have a few hundred or thousand dollars? Let's make it so they can't go out and base their transaction on some other thing—whatever other thing they want to base it on—in a way that can't be broken by legal tender laws. Free them up the way the wealthy are freed, for all practical purposes.

Mr. DENNIS. Just as an anecdote, recently Professor Friedman was giving a speech and he was telling how he made a considerable amount of money. He simply invested in yen. Not in American currency. Someone else's currency and that is available.

Mr. SCOTT. Well, I would argue, just to summarize quickly, that there have been some virtues in money market funds, and that they have allowed people with more modest means to at least earn a very positive rate of return adjusted for inflation over short periods of time, when they couldn't before that. In fact, that is why they have grown, and if banks want to keep deposits, large or small, they are going to have to pay the market rate. For better or for worse that has caused a convergence of cost of funds throughout our financial system.

Mr. NOWAK. That is the effect that is out there now and how we face it is going to determine what kind of interest rate costs I think will be there for the small business community.

Mr. Fary.

Mr. FARY. Thank you, Mr. Chairman.

Professor, what is the current NFIB mandate on banking?

Mr. SCOTT. I will defer to Denny for that.

Mr. DENNIS. If I may, sir.

We really have several positions, but essentially they focus around the branching laws. We are opposed basically to changes in the status of the branching laws, which would include such things as just going over State lines in the metropolitan area and things of that nature.

We are also opposed to widening the definition effectively or by other means of the term "commercial" and the use of the commercial activities of commercial banks. In other words, we would like to see them stay principally with the banking function, rather than expanding into auxiliary functions which could be interpreted to be a part of the banking phenomena or function.

Mr. FARY. Since your membership does not view availability of credit as a major problem, would you say the high cost of credit is a major factor in the high rate of business failures for small businesses? If not, what is?

Mr. DENNIS. Well, I think, first of all, that failures can be viewed from a number of perspectives. Certainly one of them is the lack of sales; absolute lack of sales has been devastating.

The second thing would be high interest rates from a couple of perspectives, certainly for certain industries, such as automobiles, housing, things of that nature, where consumer demand is contingent upon getting a loan. That falls back into the sales.

But also, as we saw on the charts, when your borrowing costs go right off the bottom line and there isn't much on the bottom line anyway, yes, yes, they have contributed.

Mr. SCOTT. The only thing that I was going to reiterate is that financing cost is the most important problem. In the last three quarters, since mid-1981, it has been ranked as the most important problem facing small business today.

Previous to that time, at least from 1978 up through mid-1981, it has been inflation. We have always seen that big jump, so, at least from interpreting the data, I would say yes, that high interest rates are a very important problem. But, as Denny says, "if sales would pick up, we would pull out of the recession," and that could provide a substantial gain to profits, you know, that would allow them to pay the interest cost and maybe it wouldn't be as important if we weren't in a recession. That is difficult to separate out.

Mr. FARY. Thank you very much. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you. I would like to request when you get a new bank financing survey if you could submit that to the subcommittee, we appreciate adding that to the record. Will this be in that timeframe?

Mr. DENNIS. It will be close, Mr. Chairman, but we will at least have some tables for you.

Mr. NOWAK. Fine. Again, thank you very much for your testimony. We certainly look forward to your cooperation.

Our next witness, who has been very patient here, is Ken Auvil and he represents Small Business United of West Virginia, Inc. He is the president of New Era Homes in Belington, W. Va., a builder of modular homes. It is a pleasure to have you here and thank you again for your patience.

TESTIMONY OF KEN AUVIL, PRESIDENT, SMALL BUSINESS UNITED OF WEST VIRGINIA, AND PRESIDENT, NEW ERA HOMES, BELINGTON, W. VA.

Mr. AUVIL. Thank you, Mr. Chairman. I appreciate the opportunity to come before the committee this morning.

My name is Ken Auvil. I am a modular home manufacturer in West Virginia and we are a small State. We are probably the largest homebuilder in the State with about 1,100 homes to our credit.

I am also president of Small Business United, which is a new grassroots organization in West Virginia, that is becoming an advocate for the small business organizations, small business people within our State.

Before I start on my prepared remarks, I would like to comment, Mr. Chairman, on a couple of comments that you have made. I have a very serious concern about the structure. I am not an expert in the area of financial structure, but I have some real serious concerns about the changes in the structure of economic policy, banking policy in the country.

I think the baseline of any economic policy changes that this Congress has to consider always has to go back to the impact upon the individual, whether he is a pawn or practitioner, whether he has a human scale environment to work within, whether he can buy a home, whether he can exercise economic options or whether he is a pawn of the system. I think that is a baseline question always in any economic policy.

I have a great concern about the concentration of economic power that I have been seeing. This country has taken great pains to have a separation of political power right in its Constitution, but I don't think we have done the same thing in terms of separation of economic power and I will paraphrase Lincoln for a minute. I have made this comment at a few West Virginia speeches recently to our small business groups. Lincoln said we couldn't remain half slave, half free and I say we can't remain democratically free and economically slave and so, I do have a great concern about concentration of economic power.

I am not opposed to large business. We need our large businesses, but we also need the balance of the small business community that we have had over a long period of time. Big business left to its own devices sometimes goes the way Chrysler has done where we see large business and large labor cozying up to each other, coming forth with a product that is not serviceable, that is not competitive and where 70 percent of the workers who make $30 an hour are not happy with the work. So, we are not against big business, but we also don't like to foresee an economy that is made up of the Exxons, the Chryslers, and General Motors of the world. We don't believe that is healthy for the American system. With that comment, I will go to my prepared text and not impose further upon your time.

I appreciate the opportunity that you have given me this morning. The facts that small businesses employ most of our people in West Virginia, provide the bulk of the new jobs, and are the most innovative are well-known already to you. That small businesses' most severe problems remain capital formation and retention is

also well-known. And you are aware that a local bank is often the only place that we can seek capital or credit. They provide 70 to 80 percent of all the institutional lending to our small businesses.

Most of the small firm's money comes from the owner's own resources or his family or his friends. Why aren't smaller local banks more involved in lending to small businesses? I am not a banker, but my business is a substantial borrower and bank members of Small Business United of West Virginia have provided me with some of the more technical information that I am presenting to you this morning, hopefully, to help answer those questions.

The loans which I have obtained which are enabling me to survive in the current economic recession, which has cut our industry's income to more than half and directly and indirectly created unemployment of 20 percent or greater, are based on the value of my company's and my own personal fixed and current assets. I have a revolving line of credit against receivables and inventory and a term loan based upon my fixed assets, both plant and machinery.

While the interest rate is surely higher than I would like to be paying—it cost me an additional $100,000 in interest last year, a cost that I could not in these economic times pass along—the bank is enabling me to remain in business and keep my 55 workers employed.

This type of loan has often been obtained from commercial finance companies, not banks. It is asset-based and should be more utilized by banks. It is becoming more and more apparent that for our small businesses to survive and prosper, bankers are going to have to consider such a lending device.

I can honestly say that had it not been for an intelligent, forward-thinking banker who knew the value of my company and who is concerned about the businesses in his community, 500, or half of the homes that we have built, probably would not have been built in West Virginia by the employees and management of New Era Homes. By thoroughly, and I might add, very carefully appraising my assets and my company's potential, New Era Homes is surviving these economic times with the help of the bank. We are partners. Not only has the bank provided the necessary funds for our survival, but has, when it was needed, provided management assistance and moral support, something that can make it far easier for a harried, small businessman to cope with his problems.

My banker understands that my small business and the many others in West Virginia provide not only jobs in our communities, but add substantially to the quality of life for our employees, their families, and other citizens. He knows who supports the band when they need uniforms, the volunteer fire department when they need new equipment, and any of the other special projects requiring community support for their existence.

He also understands that the balance sheets sometimes appear weak, as do many other small business balance sheets besides mine—in fact, most others. New Era Homes is not Union Carbide and the financial world in which it operates is totally different. We do not have deep cash reserves. We do not have diversified holdings, spreading our economic vulnerability into the many sectors of the economy. And because we depreciate our assets as rapidly as

possible to reduce tax impacts and maintain cash flow, our balance sheet does not accurately reflect the value of our company.

This is not to say our banker and other successful bankers who are utilizing asset-based lending to small businesses are not tough bankers. They are extremely tough. They know exactly the real value of my company and have an active and ongoing interest in the competence of its management. They are not only concerned with the interest that can be made from my loan, but with the success of my company.

Not enough banks are utilizing asset-based lending, however. More attention must be focused on this device and bankers must train their people to be more accurate and intelligent appraisers of a company's value. I have attached two articles for your review, stressing this point. One is from a recent INC. magazine, the only national magazine concerned exclusively with small business. The other is from the April 1982 issue of the American Banking Association Journal. Both articles exhort bankers to strongly consider asset-based lending as one of the only viable means of providing much needed capital to many smaller firms.

There is, however, what I believe to be an impediment to many small bankers providing or even considering such asset-based loans to small, entrepreneurial firms. The procedures followed by the Office of the Comptroller of the Currency in the examination of national banks appears to unnecessarily discourage lending to small businesses such as mine. Bank examiners perceive lending to small businesses as inherently riskier than other loans, even though the objective data to support that contention is ambiguous, according to the interagency task force on small business finance, "Studies of Small Business Finance," released in January of this year. Mr. Dennis—I believe it was Mr. Dennis—tread upon that subject a little earlier of the automatic classification of small business loans in many cases as substandard and I would encourage you to look at that, by the way.

It appears that bank examiners bring to the examination process a bias against loans to small businesses, particularly new small businesses. That was revealed in the December 1981 "Studies of Small Business Finance" by the interagency task force. This attitude is reflected in the unthinking criticism of credit extended to small businesses, often because either the business appears to be undercapitalized, a very common problem for small business, or the businesses' financial status appear to be weak. Some of my bank members of Small Business United of West Virginia have indicated that three factors contribute to that bias and encourage its continuance, particularly against asset-based loans to small businesses. They are: (1) Broad discretion given to examiners in criticizing or classifying loans which individually do not evidence any loss potential; (2) the lack of specific guidelines for accurately judging the safety and soundness of small business loans; and (3) the lack of well-defined enforcement policy resulting in the use of formal action, where such action is not warranted.

These factors have a chilling effect on bank loan officers and a reform of the examination system to remove the built-in bias is critical to the future of small businesses being able obtain the needed capital. The commercial banking system is the ideal vehicle

which, through creative lending, including asset-based loans, can create the needed growth in our small business sector.

What is required is a general change of attitude by the OCC and the national bank examiners toward lending to small businesses such as mine. We are traditionally undercapitalized, particularly when judged by the same standards applied to large businesses. National bank examiners are doing no service to our country when they apply the same formula review to small business loans as they do to loans to larger companies made by larger banks.

The banks in West Virginia and most areas of the country are not the Bank of America or Mellon Bank. Their customers are not generally United States Steel, or Exxon, or the rest of the Fortune 500. The customers are, however, the small firms of this Nation who provide more than half the current jobs, almost all the new jobs, and the bulk of the innovative technology.

Straying from my remarks for just a moment, it has been my personal experience that regulators, and not just bank regulators, overregulate the things that are simple and underregulate the things that are big and complicated, where, incidentally, most of the dangers lie. That philosophy works against small business in a State like West Virginia which is a small rural State. If you apply the same lending standards that you apply to Mellon and Chase Manhattan to the West Virginia standards, you will curtail lending dramatically. It presents an additional, particular problem because 85 percent of the deposits of this country are under control of 8 percent of the banks, I am told and so sometimes the emphasis of the examiners are in the wrong place.

Specific guidelines should be developed for judging small business loans, which would require examiners to ascertain the actual risk that such loans pose. They should be required to consider such factors as the actual present value and the salability of assets securing asset-based loans; the extent to which the return on the loan offsets the risks taken by the bank; actual performance under the loan and actual monitoring capability and performance by the bank with respect to such loans. In essence, positive encouragement of safe and sound small business loans should be part of the OCC examination policies.

Such modifications, according to Small Business United of West Virginia, bank members and others, would serve the goal of assuring safe and sound banking practices while at the same time permitting bankers to exercise good business judgment in providing credit to promising and innovative small businesses. In such a climate, banks should recognize that the profitability and value of asset-based lending will generate economic growth, employment, and further capital formation.

Currently, the President's Task Force on Regulatory Relief is looking into this problem and I applaud their interest. I would also like to specifically thank the Office of Advocacy and the Chief Counsel, Frank Swain, who have been reviewing this situation as part of their responsibility under the Regulatory Flexibility Act.

Along that line, if I may digress a moment, the Office of Advocacy, originally under the leadership of Mr. Stewart and now with Mr. Swain at the helm, is a most potent ally for small business. I fear, as do many, many other small entrepreneurs, that without

their dedication to the critical importance of our Nation's economic engine, small business, we would be suffering even greater damage in this devastating economic climate. Any effort on the part of this committee and the Small Business Committee as a whole, which would strengthen and support the Office of Advocacy, will be greatly appreciated by the Nation's small business owners.

I appreciate your interest in my comments and urge that you seriously research and review the situation I have outlined. Access to credit, along with the increasingly severe problem of high interest rates, are of major concern to my small business colleagues in West Virginia and around the country.

These problems will become even more pronounced, I fear, as the implementation of new banking regulations regarding interstate banking and the growth of financial service components of such traditionally nonfinancial companies as Sears begin to impact upon the marketplace.

While I am not sufficiently capable of discussing that impact in detail, almost any small business owner in this Nation knows that his clout with large, bureaucratic organizations, banks, businesses, or government is minimal at best. He must rely upon his own local banker to a great degree and we are seeking to assure that our local bankers are aware of the value of asset-based lending in carving out a valuable niche for themselves and that government regulation does not dissuade that banker from utilizing that device to aid small firms.

I would like to point out a couple of other things that I didn't mention in my prepared remarks. I heard the money market fund being kicked around this morning and I have heard in Washington recently a discussion of loose cannons rolling around on the deck and I would like to add that if there is a loose cannon rolling around on the deck of the American economy, I would say it is the unregulated money market funds.

They are not only disrupting lending in the small communities, that we have seen already, in the hearing this morning, but they are going into investments that are unregulated. They are becoming mammoth in size and I am not impressed by the fact that people tell me that 50 percent of those funds are invested in the biggest banks in the country. I think the more important question is where are those funds, those high cost funds, ultimately ending up? And I hope for the sake of the health of our banking institutions it is not too much in Poland and too much in those foreign investments and so forth. But I think that is a really serious question. I can't comment upon the impact of where those funds are being invested at those high rates. I think the Congress should be concerned about that. I am concerned at the local level.

As a real estate syndicator and investor, myself, you walk into the market today and ask your local investors to support the small apartment project and so forth and he is absolutely uninterested because he can put his money in a piece of paper that puts money who knows where. He is absolutely uninterested in doing a good real estate investment in his local community.

So, I would add that comment. I would also add the final comment that we are organizing Small Business United at this point in time in West Virginia and traveling around the State. Being a

former politician myself, as a former legislator in the sixties in West Virginia, there is a common view that is coming to me from our people, both Democrat and Republican, that we are really concerned about this economy. We are concerned about what is happening in Washington and that the time for finger pointing to the past and to the Democrats, the Republicans, or the White House, or the Congress is past. Many of the people that I have talked to feel that if we do not make some dramatic changes in the direction of this economy and allow this economy to breathe—and typically the number of months I hear kicked around is 12 months—we are going to be in serious trouble in this country and facing some economic crisis.

Of course, that is a prediction, not based on a lot of fact, but a gut feeling that is coming out of those meetings. They are concerned, really concerned, about the finger pointing and looking to the past. We hope somebody will find a middle ground and I applaud the committee's interest and encourage you to move more dramatically, more rapidly to find some answers as to why the interest rate isn't coming down.

I brought along two or three newspapers that I will leave that are not a part of the testimony, three or four headlines in West Virginia's three or four papers yesterday. A third of the State's families are involved in the layoffs. Hunter Steel in Huntington is closing. This is the kind of headlines—in case you haven't had enough bad news on the Hill, I brought these up for you this morning and I will be glad to answer any questions.

[Mr. Auvil's prepared statement with attachments follows:]

PREPARED STATEMENT OF KEN AUVIL, PRESIDENT, NEW ERA HOMES, BELINGTON, W.VA., AND PRESIDENT SMALL BUSINESS UNITED OF WEST VIRGINIA, INC.

Mr. Chairman, Congressmen. My name is Ken Auvil. I am founder and President of New Era Homes, located in Belington, West Virginia. We are the largest builder of modular homes in our state and aim our product primarily at low and moderate income residents. I am currently also the President of Small Business United of West Virginia, a grassroots organization dedicated to providing effective small business advocacy in our state and at the federal level when we feel we can be helpful.

I sincerely appreciate the opportunity you have given me. The facts that small businesses employ most of our people in West Virginia, provide the bulk of the new jobs, and are the most innovative are well-known to you. That small businesses most severe problems remain capital formation and retention is also well-known. And you are aware that a local bank is often the only place to seek capital or credit. They provide seventy to eighty per cent of all institutional lending to small businesses.

However, most of a small firm's money comes from the owners resources, his family or friends. Why aren't smaller local banks more involved in lending to small businesses? I am not a banker, but my business is a substantial borrower and bank members of Small Business United of West Virginia provided me with some of the more technical information I am presenting to, hopefully, help answer that question.

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The loans I have obtained, which are enabling me to survive in this current recession, which has cut our industry's income more than in half and directly and indirectly created unemployment of 20 per cent or greater, are based on the value of my company's, and my own personal, fixed and current assets. I have a revolving line of credit against receivables and inventory and a term loan based upon my fixed assets, both plant and machinery. While the interest rate is surely higher than I would like to be paying — it cost me an additional $100,000 in interest cost last year, a cost I could not in these economic times pass along -- the bank is enabling me to remain in business and keep my 55 workers employed.

This type of loan has often been obtained from commercial finance companies, not banks. It is "asset-based" and should be more utilized by banks. It is becoming more and more apparent that for our small businesses to survive and prosper, bankers are going to have to consider such a lending device. I can honestly say that had it not been for an intelligent, forward-thinking banker who knew the value of my company and who is concerned about the businesses in his community, 500 home probably would not have been built in West Virginia by the employees and managment of New Era Homes. By throughly, and,I might add, very carefully, appraising my assets and my company's potential, New Era Homes is surviving these economic times with the help of the bank. We are partners. Not only has the bank provided the necessary funds for our survival, but has, when it was needed, provideded management assistance and moral support, something that can make it far easier for a harried small businessman to cope with his problems.

My banker understands that my small business, and the many others in West Virginia, provide not only jobs in our communities, but add substantially to the quality of life for our employees, their families and the other citizens.

He knows who supports the band when they need uniforms, the volunteer fire department when hey need new equipment and any of the many other special projects requiring community support for their existance.

He also understands that balance sheets sometimes appear "weak", as do many other small businesses' balance sheets besides mine. In fact, most others. New Era Homes is not Union Carbide and the financial world in which it operates is totally different. We do not have deep cash reserves. We do not have diversified holdings, spreading our economic vulnerability into many sectors of the economy. And, because we depreciate our assets as rapidly as possible to reduce tax impacts and maintain cash flow, our balance sheet does not accurately reflect the value of our company.

This is not to say our banker, and other successful bankers who are utilizing asset-based lending to small businesses are not tough bankers. They are extremely tough. They know exactly the real value of my company and have an active and on-going interest in the competence of its management. They are not only with the interest that can be made from my loan, but with the success of my company.

Not enough banks are utilizing asset-based lending, however. More attention must be focused on this device and bankers must train their people to be accurate and intelligent appraisers of a company's value. I have attached two articles for your review stressing this point. One is from a recent issue of INC. magazine, the only national magazine concerned exclusively with small business. The other is frm the April 1982 issue of the American Banking Assocaition Journal. Both articles exhort bankers to strongly consider asset-based lending as one of the only viable means of providing much needed capital to many smaller firms.

There is, however, what I believe to be an impediment to many small bankers' providing or even considering such asset-based loans to small, entrepreneurial firms. The procedures followed by the Office of the Comptroller of the Currency in the examination of national banks appears to unnecessarily discourage lending to such small businesses as mine. Bank examiners perceive lending to small businesses as inherently riskier than other loans, even though the objective data to support that contention is ambiguous, according to the Interagency Task Force on Small Business Finance, Studies of Small Business Finance, released in January of this year.

It appears that bank examiners bring to the examination process a "bias" against loans to small businesses, particularly new small businesses. That was revealed in the December 1981 Studies of Small Business Finance, by the Interagency Task Force. This attitude is reflected in the unthinking criticism of credit extended to small businesses, often because either the business appears to be undercapitalized -- a very common problem for small business --or the businesses financial appears to be weak. Some of my bank members of Small Business United of West Virginia have indicated that three factors contribute to that bias and encourage its continuance, particularly against asset-based loans to such small businesses. They are:

(1) broad discretion given to examiners in criticizing or "classifying" loans which individually do not evidence any loss potential,

(2)the lack of specific guidelines for accurately judging the safety and soundness of small business loans, and

(3)the lack of well defined enforcement policy resulting in the use of formal action where such action is not warranted.

These factors have a chilling effect on bank loan officers and a reform of the examination system to remove that built-in bias is critical to the future of small businesses being able to obtain needed capital. The commercial banking system is the ideal vehicle which, through creative lending, including asset-based loans, can create the needed growth in our small business sector.

What is required is a general change of attitude by the OCC and national bank examiners toward lending to small businesses such as mine. We are traditionally undercapitalized, particularly when judged by the same standards applied to large businesses. National bank examiners are doing no service to our country when they apply the same formula review to small business loans as theydo to loans to larger company's made by larger banks. The banks in West Virginia, and most areas of the country, are not the Bank of America or Mellon Bank. Their customers are not generally U. S. Steel or Exxon, or the rest of the Fortune 500. (There customers are, however, the small firms of this nation who provide more than half the current jobs, almost all the new jobs, and the bulk of our innovative technology!)

Specific guidlelines should be developed for judging small business loans which would require examiners to ascertain the actual risk that such loans pose. They should be required to consider such factors as the actual present value and saleability of assets securing asset-based loans; the extent to which the return on the loan offsets the riskes taken by the bank; actual performance under the loan and the actual monitering capability and performance by the bank with respect to such loans. In essence, positive encouragement of safe and sound small business loans should be a part of OCC examination policies.

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Currently, the President's Task Force on Regulatory Relief is looking into this problem and I applaud their interest. I would also like to specifically thank the Office of Advocacy and the Chief Counsel, Frank Swain, who have been reviewing this situaltion as part of their responsibility under the Regulatory Flexibility Act. Along that line, if I may digress a moment, the Office of Advocacy, originally under the leaderhip of Milt Stewart and now with Mr. Swain at the helm, is a most potent ally for small business. I fear, as do many, many other small entrepreneurs, that without the their dedication to the critical importance of our nation's economic engine, small business, we would be suffering even greater damage in this devastating economic climate. Any effort on the part of this committee and the Small Business Committee as a whole, which would strengthen and support the Office of Advocacy, will be greatly appreciated by the nation's small business owners.

I appreciate your interest in my comments and urge that you seriously research and review the situation I have outlined. Access to credit, along with the increasingly severe problem of high interest rates, are of major concern to my small business collegues in West Virginia and around the country.

Those problems will become even more pronounced, I fear, as the implementation of new banking regulations regarding interstate banking and the growth of financial service components of such traditionally non-financial companies as Sears begin to impact upon the marketplace.

While I am not sufficiently capable of discussing that impact in detail, almost any small business owner in this nation knows that his clout with large, bureaucratic organizations,-banks, businesses or government-is minimal at best. He must rely upon his own local banker to a great degree and we are seeking to assure that our local bankers are aware of the ~~value of asset~~-based lending in carving out a valuable market niche for themselves and that government regulation does not disuade that banker from utilizing that device to aid small firms.

I will be happy to answer any questions you may have.

Banks should change their thinking on asset-based lending

There is more need of it now, but to succeed at it, banks have to be more aggressive

By William H. Rentschler

The trend in the '80s for financing small and medium-sized companies is strongly in the direction of asset-based lending.

What that means is a surge in the loan volume and "acceptability" of commercial finance companies and an acceleration of the industry-wide move by the big money-center banks to get into the same game. Medium-sized banks and even small banks with a taste for commercial accounts would be well advised to take a hard look at the enormous potential of asset-based lending.

Most asset-based lenders advance funds against both current and fixed assets, which they appraise with gimlet eyes, sending in skilled auditors to [illegible] a potential borrower inside out.

The more creative lenders often put together a loan package that may include a revolving line of credit against receivables and inventory, and a term loan based on fixed assets (either plant and other real estate or machinery and equipment, or both).

Typically, a skilled asset-based lender advances around 80% on eligible receivables under 90 days old (in some cases under 120 days old). Inventory loans range from 20% to 50% of book value of raw materials and finished goods, with most lenders shying away from in-process inventory.

"Knockdown" appraisal. On fixed assets, commercial finance lenders generally demand a "knockdown" appraisal—the value in case of a distress sale. They may lend up to 80% of that value, or 40% to 65% of fair market value, which is often substantially greater than book value.

Many factors enter into the evaluation of real estate for loan purposes, but in today's market, with interest rates still high, a relatively short-term "commercial" loan against real estate makes good sense.

Recently, asset-based lenders have been increasingly successful because they are best structured to grasp the whole picture quickly and to move with haste.

Most are generally realistic when coming up with an adequate amount of money to meet the real needs of the borrower. Their rates are often higher than bank rates—usually 3 to 5 percentage points over the prime rate. However, the prime is rarely available to smaller borrowers, so the actual "gap" generally works out to only 2 or 3 percentage points.

Banks join ranks. While asset-based lending has been traditionally dominated by commercial finance companies, many banks have joined the ranks by either setting up or acquiring bonafide commercial finance operations. One concern they have often emulated is a pioneer in the field: Chicago's Walter E. Heller & Co., Inc.

One indication of this company's status is that big banks and other competitors lacking in-house expertise often raid Heller's ranks when they want to start or beef up their own commercial finance operations.

Last year, Barclays Bank of London took a big step in acquiring Aetna Business Credit, Inc., an established commercial lending subsidiary of Aetna Life & Casualty. More recently, California's Security Pacific National Bank picked up A.J. Armstrong, an old-line commercial finance company based in New York. Citicorp and Manufacturers Hanover Trust Co. of New York, Chicago's Continental Illinois National Bank, and San Francisco's Crocker National Bank and Wells Fargo Bank are all involved in asset-based lending, often providing such services to their regular customers and others. Among smaller banks, Lake Shore National, Chicago, has been long involved in receivables financing.

Reluctancy. Yet, asset-based lenders still have a large jump on all but a handful of banks. Why? Perhaps because many banks entered the business timidly and continue to drag their feet. Bankers, typically disdainful of what they often regarded as "last resort" commercial lenders, have been reluctant to follow their example. Because banks are traditionally more conservative in their lending procedures, they have to be shown that this more creative approach to financing is legitimate and safe.

Since the awakening among the larger banks and, in some cases, among medium-sized operations, bankers are beginning to understand that asset-based lending is perhaps the most secure form of lending. The sophisticated, hard-eyed scrutiny of assets by auditors and loan officers acts as excellent protection for the borrower as well. No such lender will make a loan unless he's reasonably sure he'll get his money back if forced to liquidate.

Still, in many cases, a $200,000 loan to a rapidly-growing entrepreneur often stymies a banker more than a $20 million loan to a big public company. This, however, is why banks were the major nail-biters and potentially the biggest losers when such prestigious firms as Penn Central, Lockheed, W.T. Grant, Chrysler, and International Harvester faltered.

Small company potential. Many smaller, more entrepreneurial companies deserve more consideration than banks, typically, are willing or able to give them. And asset-based

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Mr. Rentschler is the founder and principal of The Cherokee Associates, a consulting firm in Lake Forest, Ill. which specializes in acquisitions, financing, and strategic planning for privately-owned companies. He is also chairman and CEO of a steel fabricating company in Greenwood, Miss.

"Many banks entered asset-based lending timidly, and continue to drag their feet"

lending may provide more banks with an entree to this potentially rewarding arena.

The perceptive banker will discern the reasons for the success rate of the better asset-based lenders. Increasingly, companies in the $1 million to $50 million range, which produce most new jobs in this country, as well as some larger companies, find themselves drastically squeezed or even cut off from funds needed for growth, modernization, or expansion through acquisitions.

This is because venture capital firms are extremely choosy and slow-moving, and are generally attracted to high-technology companies and other high-fliers. Furthermore, commercial banks—the traditional source of business loans—in many cases either can't or won't provide the support needed by small and medium-sized companies. This condition continues to worsen in today's depressed and volatile economic climate, forcing many such companies to the wall, over the cliff, or into a holding pattern.

Examples. Nevertheless, some small and medium-sized companies have found asset-based lenders to be their saviors. I'll cite two recent examples where asset-based lending was used successfully when traditional sources of funding were not available to the company.

In the first example, an individual bought a small-town printing company for $4.5 million. The seller took back notes for half the purchase price, with machinery and equipment as collateral, and leased the plant to the buyer. The asset-based lender provided about $2 million secured by receivables and inventory. When the deal was done, all parties involved agreed they didn't know of a bank that would have moved fast enough nor have provided the financing needed to close. Yet there was no question about the solidity of the loan.

In the second case, a small local bank—part of a larger company—advanced two-thirds of the required funds on fixed assets at the prime rate—*after* an asset-based lender had committed to make a loan against receivables and inventory and monitor the *total* loan. The commercial finance company charged five percentage points over the prime, but the "blended" rate worked out to a favorable 1.67% over prime.

Expertise needed. Clearly, asset-based lending is here to stay—and to grow. Foresighted bankers would be wise to consider it as a strategic key to the development of a profitable, secure loan portfolio for their institutions.

Luring talent from experienced asset-based lenders is perhaps the best way for a bank to get started in this area, because expertise in asset-based lending is essential. Such skill rarely exists among a bank's personnel. And training for such lending techniques is costly and often inadequate. Competition is understandably intense for competent, creative asset-based lending executives, but the pool of talent is fairly sizeable and growing. □

CAPITAL

LENDERS OF LAST RESORT

When everyone else has turned you down, it's time for an asset-based loan.

By Mark Stevens

A growing number of smaller firms find that aggressive, hungry bankers are putting out new welcome mats. Over the past few years, dozens of major banks have dramatically expanded their "asset-based" lending.

Asset-based lenders are often lenders of last resort to companies that more conservative sources, such as the loan officer at your local bank, judge to be poor credit risks. They make secured loans based on a careful review of your assets' liquidation value. Accounts receivable, inventory, machinery, buildings, real estate, and even, in some cases, trademarks and patents can be used as collateral. Interest rates on asset-based loans generally float 3% to 5% over prime.

Here's the best part: In inflationary times, when the actual value of assets is often more than your balance sheet indicates, asset-based lenders may be able to lend you several times the amount your balance sheet shows as the stockholders' equity. They don't demand that you meet the same informal criteria applied by ordinary bank loan officers for unsecured loans.

Traditionally, special finance companies did most of America's asset-based lending, capturing a market that banks considered too risky. Monroe R. Lazere, president of Lazere Financial Corp. in New York, explains their role: "In many cases, unsecured borrowing doesn't work for small businesses. That's why they come to firms like ours. Thousands of good growth firms need money badly but cannot qualify for unsecured bank loans on the strength of their balance sheets alone. Or the business may be too new to interest an unsecured lender. And even those that meet the banks' criteria may be severely limited in the amount of money they can borrow. But because we look at prospective borrowers differently, we can offer major loans to the same applicants the banks turn away."

Nowadays, many finance companies have been acquired by bank holding companies. And they all face well-heeled competition from banks who have hired away top finance-company people to head their own asset-based lending subsidiaries. Stephen Diamond, for instance, was an executive with Walter E. Heller & Co., one of the nation's largest finance companies; he now heads Chase Manhattan Corp.'s Chase Commercial Corp. "Until recently, banks viewed themselves primarily as collectors of deposits who had to make very safe investments," says Diamond. "They left the riskier segment of the market to the finance companies.

"But this changed in the late '70s because banks started to see themselves not as collectors of deposits but as financial intermediaries who had to find all sorts of ways to make money lending money.

Most banks' asset-based finance subsidiaries are run separately from their networks of branches. So many small businesses rejected for ordinary bank financing never hear that the same bank might be able to meet their needs with an asset-based loan. Diamond admits that, in many cases, "you have to know to ask for it."

Lending policies vary among asset-based lenders. All look closely at the assets being pledged, but while traditional finance companies tend to lend solely on the strength of the assets themselves, the bank-owned companies are generally more conservative. They evaluate whether your cash flow will be sufficient to repay the loan, as well as whether your assets, if liquidated, would be sufficient to cover it.

Asset-based loans aren't for lemonade stands: Companies like Lazere Financial won't handle deals for less than $100,000, and even the smallest finance companies rarely look at a loan of less than $25,000.

If you receive an asset-based line of credit secured by your receivables, you must forward the checks directly to the lender as your customers pay their bills. Credit lines secured by receivables are usually reviewed annually, by securing loans with fixed assets you may be able to borrow for up to seven years. The maximum loan is usually about 80% of your assets' liquidation value.

Despite asset-based loans' high interest rates, many businessmen find them a vital source of funds. "In talks with banks, we quickly learned that our borrowing needs greatly exceeded the amount they were willing to lend us," says Joseph Kassel, president of Kassel Corp., an importer and manufacturer of wallpaper materials. "So we turned to asset-based lending. We've been using it for six years now and find it an excellent business tool. Our balance runs up to $1 million at a time."

Entrepreneur Douglas Stevens, a former Time Inc. executive, acquired a company with loans secured by the company's own assets—a common technique. For years he had watched a small, thriving firm, H. George Caspari Inc., a greeting-card publisher. When he learned Caspari was up for sale, he jumped at the chance to buy it.

"But I couldn't get enough money from the banks," he says. "They focused almost exclusively on the debt-to-equity ratio, and I fell short there. Fortunately, the asset-based lenders are more interested in the quality of the assets. We pledged the receivables of Caspari to get the loan." The seller took notes payable over several years. Stevens borrowed from Lazere Financial each year to make the payments on the notes, repaying with the business's cash flow.

"The deal has worked out wonderfully," Stevens says. "I own the firm I wanted in spite of the banks' lack of cooperation. What's more, there is also a side benefit in working with the asset-based lenders. The discipline of the relationship forces you to get good documentation of your assets and to keep close tabs on receivables."

For a list of asset-based lenders across the nation, write the National Commercial Finance Conference Inc., One Penn Plaza, New York, NY 10001. □

Mark Stevens is author of The Big Eight, *a profile of the nation's leading accounting firms, and other books.*

Mr. NOWAK. Thank you very much for your testimony. It gives us another insight into the problems out there. I am glad you brought to this committee's attention the bank examiner problem, which we will look into further with the Comptroller of the Currency and others to see where the differential is being made and try to assess the impact nationally.

Your statement reflects a personal knowledge of how your bank in West Virginia is examined and as you said, I think that has a tremendous impact upon the wiliingness for these banks to even look at a small business loan. It probably scares them to death to load an arbitrary percentage into their portfolio because they know they are going to get examined, and they are going to avoid the criticism as much as any of us would if we were in that same position. So, I think that is a very good point.

As to the effect of the interest rate, just looking at your own business, the modular homes, I take it, are financed to a large degree. I wonder if you could tell me about that financing, how that financing has changed over the last few years? How long have you had the business, Ken?

Mr. AUVIL. I have been in the construction business for 20 years, started my manufacturing business in 1974, the modular manufacturing in 1974.

Mr. NOWAK. Do you make these on a line?

Mr. AUVIL. We have an assembly line and we produce between 100 and 200 houses and apartments per year. We are a small company.

Mr. NOWAK. What has been the change to the people that you are selling? Are you selling and renting or are you selling only? You mentioned investors. I assumed that you had some rental properties?

Mr. AUVIL. Traditionally, Mr. Chairman, we were single-family home builders building to the moderate and modest income people of West Virginia, but in the last 2 years, we have shifted from 75-percent single family to 75-percent commercial, multifamily. We have just frozen the single family home buyer right out of the market in our State. They have been frozen out of the market with a mortgage rate of 16, 17, 18 percent. It is not affordable, so we have chased the commercial market. Unfortunately, we have not been able to raise prices in a competitive market.

The modular companies are being sold every day. Every day I get advertisements for companies for sale. It has been very competitive for the 50-percent share of the market that is left and, obviously, we can't raise prices. Our interest rate last year, mine alone, as I mentioned in testimony, was an extra $100,000 and sales of, say, $2.5 million. There is nothing I can do about that. I am a small business. Whatever the bank asks for current money, it is going to get. I paid up to 22 percent and, so, consequently, we have been fortunate only because we have been innovative and keep our prices down.

Mr. NOWAK. Are you able to build new? You say modular and we come up with the thought of the prefab. I guess everybody does that. And, yet, with the price of constructed housing, when you look at the differences, I would assume you are able to build at a

lower cost. When you look at a conventional type of an apartment, what do you do? Actually stack these next to each other or——

Mr. AUVIL. You would not be able to recognize the difference between our construction and standard construction when it is on site. So, our apartments and townhouses look like everybody else's apartments and townhouses.

Mr. NOWAK. It was interesting that you made the comment, too, about the concentration of power. With the advent of the money markets, what we have seen, of course, has opened up great competition. It is ironic, you know, you look back and try to get more data on this, but the reason for the reg. Q in the thirties was to prevent the large institutions from competing with the many small institutions throughout the country and to encourage the small institutions to build up. By keeping the interest rate relatively low, until we had this jump in inflation, we saw the growth that was available in this country. I find it ironic that everybody condemns the forties and fifties and sixties and even the seventies where you had available that home for the average worker in this country and now we have priced it out of probably 90 percent of the market. If they wanted to buy a home, they couldn't do it anyway.

And, yet, on the one hand, we say, well, we want to give the banks the opportunity to compete and your point about the comptrollers shows one way that they are not going to be competitive, especially on the side of the depositor.

As for telecommunications, with the new technologies, it is not going to be long until Sears and everybody else is in there. You won't have to build a structure in the community, for a bank and a teller there. They will become faceless with the technologies, and you are going to be able to get the highest rate by picking up the phone, sending in your check or whatever. Yet, the small businessman has to have somebody there, as you explained in your statement, to know his business and take some interest in it if he expects to grow.

So, the lender is going to be going to the bank which is not going to be getting the deposits to support the lending for the growth of that community-based business. I am just struggling here with trying to comprehend the implications of opening this all up and letting the banks compete on the same basis as the money markets, and eventually Sears and these large institutions. I don't see a real deposit base for the smaller organization because people will invest every spare dollar they have where they are going to get the highest possible return. They are not going to be worried about your credit problems or anybody else's, and I think this hasn't really been focused on when we look at it. Let's review and change Glass-Steagall and throw out reg. Q and everything will be on a competitive basis as the Treasury Secretary wants it.

Yet, we see that may get you into a permanent high interest rate structure forever and some say, well, that is where we should be. But there is going to be a lot of disparity and, I think, a lot of restriction out there in the communities because of that.

You mentioned this problem with the bank examiners. Do you know of any small businessmen who have tried to do anything specifically with the Comptroller on this issue?

Mr. AUVIL. I am aware of banks in West Virginia that have tried to work with their businesses, but I honestly believe there is a bias. I think the regulators are more comfortable working with the larger institutions that go by the book. I think the answer to your question is "yes," I can give this committee specific examples of that happening. I could provide that kind of testimony if the committee would want to hear it from professionals in the banking industry.

Mr. NOWAK. I think we would like to have that. I think that could give us a starting point.

Mr. AUVIL. It would be very easy for us to provide that.

Mr. NOWAK. To see what is happening out there and we could use it.

Rick, do you have any questions you would like to ask?

Mr. CENTNER. No, thank you.

Mr. NOWAK. John, do you have any further questions you would like to ask?

Mr. FARY. I have no questions. Thank you very much, Mr. Chairman.

Mr. NOWAK. We want to thank you for your testimony and especially for your patience. We are going to go through and digest most of this testimony; we may be back to you with some specific questions after that time. We want to get wide distribution of this information to the Members so that as we go through the banking deregulation, which is the purpose of the hearing, we don't exacerbate the problem of small business accessibility to the funds and not only the funds, but to an individual out there who is available and capable of understanding how that business is operating.

But I am just thinking that if we don't have some way to try to adjust this interest rate, we are going to see a greater impact on the small businesses in this country.

Again, we appreciate your testimony. Thank you very much.

Mr. AUVIL. Thank you.

[Whereupon, at 12:45 p.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

[The following prepared statements were submitted for insertion in the hearing record:]

PREPARED STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION

The Securities Industry Association appreciates the opportunity to present its views on bank deregulation and its potential impact on small businesses. We would like to address the issue from the point of providers of debt and equity capital for established corporate and government issuers and for small, emerging corporate issuers.

SIA represents nearly 500 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90% of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 25 million individual shareholders, institutional brokerage, over the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

The Glass-Steagall Act, passed 1933, removed all but limited securities activities from the purview of commercial banks in explicit recognition that concentration of economic power in banks had contributed to and exacerbated the crash of 1929 and the subsequent depression. An independent, responsive nationwide broker/dealer community severed from bank affiliation by the Glass-Steagall Act emerged and has developed competitively under the rigorous demands of private citizens, business and government. This broker/dealer community services our nation's securities needs in the most efficient capital market in the world.

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The Glass-Steagall Act's separation of commercial and investment banking has made a major contribution to the depth and diversity of the financial marketplace in the United States. It has allowed side-by-side development of different financial services industries which today offer credit and capital alternatives to the ultimate benefit of consumers, businesses, and state and local governments. It has prevented commercial banks with their special privileges and advantages from using these advantages to crowd out and eliminate other providers of financial services which do not possess those advantages. The Glass-Steagall Act has contributed to the building of confidence in a sound commercial banking system, fostered competitiveness, helped avoid undue concentration of economic power and inspired innovativeness in both investment and commercial banking. The present financial system has encouraged alternative credit and investment opportunities to flourish on a scale unparalleled in our nation's history. Such diversity is the public interest. We would not be better off with a financial marketplace dominated by large banks exercising a greater concentration of power and control over economic resources.

A major concern of small business in the United States is equity financing. While large, established corporations can raise equity capital through the retention of after-tax profits, depreciation, private placements, etc., these avenues of capital formation are often unavailable or insufficient for small business.

Regional broker/dealers play a vital role in raising much needed equity capital for small businesses as managing underwriter of their common stock offerings and as maintainers of a liquid secondary market in these issues. Without a liquid secondary market in a particular small business's securities, there is increased potential for acquisition and merger of that business due to the inability of initial investors to sell shares to other investors. While national broker/dealers tend to deal in larger issues and, naturally, larger issuers, it is the regional securities firms which play the critical role in bringing smaller businesses together with public investors.

> The existence of regional, locally oriented firms to underwrite the issues of small business is essential if such businesses are to gain access to the public market. (National Association of Securities Dealers, Inc., Report of the Joint Industry/Government Committee on Small Business Financing, May 22, 1979.)

According to a 1981 Securities and Exchange Commission/Small Business Administration study on the role of regional broker/dealers in the capital formation process, from 1972 through 1980, 1,033 corporate issuers raised $5 billion through initial public offerings. Regional broker/dealers raised $2.8 billion or 56% of the total. As cited in the study,

> "regional broker/dealers manage 79% of all initial public offering transactions, ...92% of the offerings

> of issuers with less than $10 million in annual revenue,...(and) 82% of the offerings of natural resource and high technology firms." (Emphasis added.)

The job-creating potential of these small, high technology firms gives the regional broker/dealers' role in underwriting these types of issues a particular importance and underscores the interrelated fortunes of small business and regional broker/dealers community.

Proposals currently before Congress to deregulate the banking industry and allow banks into the securities business will result in the concentration of economic power in a few large money center banks. Presently, banks control in the aggregate $1.8 trillion in assets. With the relaxation of restraints on bank securities activities, commercial banks would be able to utilize their huge asset base and advantage given them as depositing institutions to effectively dominate the investment banking arena, resulting in decreased competition in financial services and stifling of innovative financing opportunities. Regional and small investment bankers are particularly dependent on revenues from municipal revenue bond underwritings and bank participation on that market could force significant numbers to merge or go out of business, further shifting power to the major financial center banks and national broker/dealer. The focus of these large institutions is simply not upon the small business community. Nor is there any reason to believe it will be

directed that way in the future. Economies of scale and resultant profit concerns make it unfeasible for large money center institutions to concentrate on commercial or investment banking activities in local communities. Local jobs and revenues will inevitably be lost. Loans and access to capital for small business will be severely restricted as these large institutions shift money out of local communities into large established corporate financing. A recent article in the New York Times (April 25, 1982) stresses this:

> In addition, the income earned on a small-business loan, even at a high rate, is tiny compared with that earned on a big loan. For example, if the prime rate is 16 1/2 percent, and a bank makes a $50 million loan to a major company at two percentage points below the prime, the banks annual gross annual income from that loan would be $7.25 million. But the gross income from a $100,000 loan at three percentage points above prime would be only $19,500. Assuming that the cost of funds to the banks was 2 1/2 percentage points below the prime, the net pretax yield to the bank on the big loan would have been $250,000 and on the small loan, $5,500. Yet, it might have taken more time and substantially more risk to make the $100,000 loan than it did to make the $50 million loan. (Emphasis added.)

In considering proposals to modify Glass-Steagall, it is incumbent upon the Congress to insure there is not a

concentration of economic power in the hands of a few large entities resulting in a lack of competition among financial institutions and restriction of small business access to equity capital markets.

The Securities Industry Association is concerned about the effect on small and regional broker/dealers as small businesses of proposals to modify the Glass-Steagall Act to allow commercial banks to underwrite all municipal revenue bonds. In 1978 SIA surveyed its member firms on the relative importance of the municipal bond business and, specifically, of revenue bond business. Municipal bond activities accounted for 10% of the securities industry's 1977 gross revenues. Revenue bonds accounted for 65-75% of all total revenues from all municipal activities.

Based on the survey, for those firms in the municipal business, regional broker/dealers derive approximately one-third of gross revenues from municipal underwriting activities whereas national full-line firms obtain only 10 percent of gross revenues from that activity. Firms able to segregate proceeds from revenue bonds and general obligation bonds reported 80% of municipal revenues were derived from revenue bond activities. Data compiled by the SEC in 1978 show that small and regional broker/dealers underwrote 57% of municipal revenue bond issues of less than $5 million in principal and over 63% of municipal revenue bond issues of less than $1 million in principal. The importance of municipal revenue bond activity to the business of

small and regional broker/dealers and the importance of these same broker/dealers to the financing needs of local and municipal governments is evident. A significant diminution in revenues from the municipal side of a firm's business would have a severe impact on the broker/dealer's ability to convey on corporate underwriting in which he would otherwise engage.

Currently, approximately 160 banks act in some degree as underwriters of eligible municipal securities, principally general obligation bonds. A dozen large financial center banks dominate this area of bank activity. Commercial banks presently enjoy tax and regulatory advantages that do not allow for equal competition from other financial intermediaries, especially regional broker/dealers. For example, banks are allowed to deduct the interest expense of carrying municipal issues which broker/dealers are not. In addition, the unique ability of banks to attract funds at no cost (demand deposits), or at lower cost (from the Federal Reserve window) gives them another distinct advantage in providing underwriting and other services to potential municipal issuers. Recently, large banks have begun offering letters of credit to municipalities with the understanding that they will be allowed to manage or comanage the underwriting syndicate for that municipality their ability to offer letter of credit is another advantage unique to commercial banks. Expanding the powers of commercial banks to underwrite all municipal bonds without equalization of the tax and regulatory benefits possessed by commercial banks will allow for further big bank domination of this area and could fundamentally

alter the structure of the securities industry. The principal losers will be the small and regional broker/dealers. The loss of these small regional firms will inflict serious damage on the capital raising mechanism of local and municipal governments as well as on capital raising ability of small and medium size business. A recent SEC study supports this conclusion:

> "While it cannot be predicted how many, if any, firms would not remain in the securities industry due to expanded bank MRB (municipal revenue bond) underwriting, the potential exit of securities firms could lessen any competitive gains from bank entry. Moreover, because of the importance of the smaller firms in underwriting smaller issues, the loss of these firms could have an impact on the ability of small municipalities to meet their financing needs. Finally, any adverse impact on smaller, regional broker-dealers may have serious implications for the corporate business formation process, particularly for small businesses." (Emphasis added) (Bank participation in Municipal Revenue Bond Underwriting: Impact on Securities Industry Revenues) SEC, October,1979)

To insure fair and equitable competition among financial institutions, the Securities Industry Association supports a full review of the Glass-Steagall Act and of securities laws relating to bank securities activities as essential prior to any legislative change. In particular, careful study should be given to the potential impact of such repeal or modifications on the ability of small business to raise capital in the vastly attired environment that would ensue.

PREPARED STATEMENT OF JOSEPH F. SUMANSKI, ASSOCIATE ECONOMIST, INVESTMENT COMPANY INSTITUTE

June 30, 1982

Mr. Benson S. Goldstein, Subcommittee Counsel
Subcommittee on Tax, Access to Equity Capital
and Business Opportunities
Committee on Small Business
U. S. HOUSE OF REPRESENTATIVES
B-363 Rayburn House Office Building
Washington, D. C. 20515

Dear Mr. Goldstein:

The Investment Company Institute* appreciates the opportunity to submit a statement into the record of the hearing on bank deregulation and its impact on small business lending. In various legislative and regulatory proceedings money market funds have been accused by competitors of fostering every economic difficulty faced by competing financial institutions. Hearings have been held in the last two years in both Houses of the Congress and we believe that it has been demonstrated that money market funds are not responsible for the difficulties faced by certain depository institutions. The fact is, money market funds give citizens and small businesses a way to better cope with the current climate of inflation and high interest rates. At the end of 1981, we estimate over 300,000 business corporations were using money market funds and had over $18 billion of assets invested. The following is a list of just some of the benefits which money market funds provide to the national and local economies.

POSITIVE CONTRIBUTIONS OF MONEY MARKET FUNDS

1. Small business particularly benefits from the ability to manage cash and earn the returns that their larger competitors have always been able to obtain through in-house management and "zero balance" checking accounts.

2. By providing high yields, currently 13.5 percent, money market funds (MMFs) are a convenient savings media which enables small and large investors alike to cope with inflation.

*The Investment Company Institute is the national trade association of the mutual fund industry. Its members include mutual funds with over 90 percent of the assets of the industry.

3. MMFs provide liquidity and relative safety to investors, two ingredients that are highly prized in a period of economic and financial uncertainty.

4. MMFs have wide appeal because they may be used as a way to save over the long-run, as a place to temporarily "park" dollars while awaiting other developments, or as a way of efficiently managing one's cash position.

5. MMFs also provide a variety of services, including limited checkwriting and easy linkage to other fund products, and they do so at low cost.

6. MMFs give the small investor an alternative to a 5-1/2 percent yield on passbook saving which after inflation and taxes produces a negative return. For persons in the 35 percent tax bracket, a 5-1/2 percent return after allowing for taxes and a 13.0 percent inflation rate produces a "real rate" of -9.4 percent.

7. Because MMFs provide high returns and allow savers a reasonable chance to keep pace with inflation, they encourage saving. This is clearly desirable from the standpoint of public policy since saving, investment, and productivity are at historic lows.

8. As financial intermediaries, MMFs mobilize the saving of the public and allocates it in ways that help finance government activity and job-creating production and economic growth.

9. At the end of April, 1982, MMFs provided:

   (a) $35.0 billion of credit to the Federal Government and its agencies (Treasury bills and other Government securities).

   (b) $79.4 billion of financing to commercial banks (Bank CDs and repos).

   (c) $75.2 billion to business (Commercial paper and bankers acceptances).

10. The dollars flowing into commercial banks from MMFs are used to finance investment and loans to businesses, consumers, and farmers throughout the United States.

11. The commercial paper and bankers acceptances acquired by MMFs help finance businesses that are important to local economies in regions throughout the country.

12. Lending to businesses via commercial paper and bankers acceptances tends to limit inflation since borrowing costs are less than commercial bank loans.

13. MMFs also buy the CDs of larger S&Ls and are developing "packaging" techniques for channelling dollars into smaller banks and thrift institutions.

We believe that the above items, as well as their overwhelming acceptance by U. S. consumers and businesses, are ample testimony to the positive benefits provided by money market funds.

Prepared Statement of Allen Neece, Jr., Legislative Counsel, National Venture Capital Association

Mr. Chairman, you have asked us for a status report on the venture capital industry.

We are delighted to report that the professionally managed venture capital community is alive and well and is both growing and making disbursements at a record rate. The primary reason for the nearly doubling in the total asset size of our industry in the last four and one-half years is directly attributable to the lowering of the federal capital gains tax, first in 1978 and again in 1981. As is evident in the accompanying Exhibit I supplied by Capital Publishing Company (publisher of the VENTURE CAPITAL JOURNAL), the level of new capital committed to venture capital firms ranged in the mid-1970s from a paltry $57 million to an anemic $39 million. Immediately after the effective maximum capital gains tax rate was lowered to 28 percent in 1978, infusion of new private capital into our industry jumped to a level of $570 million.

Based on what has happened during the first six months of calendar 1983, an additional $1.4 billion will be invested in our industry this year as a result of the rate reduction to 20 percent last year. This level of growth, by the way, can be put in perspective by noting that there was more private capital invested in privately managed and dedicated venture capital pools in <u>each</u> of the last two years than in the previous eight years combined.

EXHIBIT I

Annual Capital Commitments and Disbursements
($millions)

Year	New Private Capital Committed to Venture Capital Firms	Size of Total Pool
Est 1982 (6/30)	$ 700	$6,500
1981	1,300	5,800
1980	900	4,500
1979	319	3,800
1978	570	3,500
1977	39	2,500 - 3,000
1976	50	
1975	10	
1974	57	
1973	56	
1972	62	
1971	95	
1970	97	
1969	171	2,500 - 3,000

From a public policy point of view, the biggest beneficiary of the increased flow of funds into venture capital firms has been the capital starved, rapidly growing small business concern.

Exhibit II reflects an almost 200 percent increase in portfolio disbursements beginning in the year following the 1978 capital gains reduction. This means that a ready source of equity capital and long-term, lower cost debt became available almost overnight to entrepreneurs who were introducing new products and services into both the domestic and international market places during a time of economic uncertainty and sustained record high interest rates. As a majority of the venture capital portfolio companies are the producers of new, state of the art, high technology applications, such investments have in turn had a disproportionately positive effect on new job creation, the level of innovation, and international trade.

EXHIBIT II

Annual Capital Commitments and Disbursements
($millions)

Year	Revised Annual Estimated Disbursements to Portfolio Companies
1981	$1,400
1980	1,100
1979	1,000
1978	550
1977	400
1976	300
1975	250
1974	350
1973	450
1972	425
1971	410
1970	350
1969	450

These conclusions are underscored by Exhibit III which shows that investments are targeted towards the most economically dynamic sectors of our economy. Communications, computer, electronics and genetic engineering related companies were the recipients of two-thirds of all deals financed in 1981. Given the extremely high risk nature of virtually all of these investments, it is safe to say that very few of those investments would have been financed except by the organized venture capital community. No other financial institution or intermediary is structured or sufficiently experienced to undertake the kind of risk where 30 to 40 percent of all money invested will be lost and only 30 percent of the companies financed will generate any appreciable gain.

EXHIBIT III

Venture Investment Activity

	Percent of Total Number of Investments - 1981
Communications	11.4%
Computer Related	30.0
Other Electronics Related	14.5
Genetic Engineering	6.2
Medical/Health Related	7.0
Energy	4.9
Consumer Related	4.9
Industrial Automation	6.2
Industrial Products	4.4
Other	10.5
Total	100.0%

It should be emphasized that the reduction in the capital gains tax rates creates a synergism between the venture capitalist and the small business owner/manager. With an increase in the reward side of the risk-reward equation, investors are more willing to assume a higher element of risk and make more of their monetary resources available to experienced venture capital managers. Likewise, would-be entrepreneurs are more willing to risk starting a new company or expanding an existing one because they will be much better rewarded if the venture is a commercial success. In short, lower capital gains rates create an invironment that is much more conducive to both the venture capital investor and the small business person, neither of which can function without the other.

Another benefit is that the majority of all venture capital investments are directed to businesses that improve upon the productivity rate of a given industry as evidenced by Exhibit IV. For instance, in 1981 half of all businesses financed and 57 percent of the dollars going to our portfolio companies directly spurred increased productivity while another 27 percent

of the remaining businesses and a quarter of all dollars invested indirectly caused an improvement in productivity. It goes without saying that without a constant increase in our country's rate of productivity, we cannot expect a vibrant economy over the long haul. If the venture community continues to invest at current levels our nation's level of productivity should continue to improve.

EXHIBIT IV

Venture Capital Investment
in Productivity Improvement

	1970-1979 Number/Dollars	1980 Number/Dollars	1981 Number/Dollars
Directly Linked	33%/43%	46%/40%	50%/57%
Partially Linked	21%/18%	23%/22%	27%/25%
Total Linked	54%/61%	69%/62%	77%/82%
Not Related	46%/39%	31%/38%	23%/18%

As we are fond of saying, venture capital is the goose that lays the golden egg. The National Venture Capital Association wants to take this opportunity to express its appreciation to you Mr. Chairman, and to the Ranking Minority Member, Mr. Marriott, and the other Members of the Subcommittee for your leadership and support in achieving the reduction of the capital gains tax rate. We are confident that small business and therefore the country will be richly rewarded because of your efforts.